OPPORTUNITIES AND OBSTACLES IN CREATING AFFORDABLE RENTAL HOUSING FROM BANK-OWNED PROPERTY

by

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Submitted to the Department of Urban Studies and Planning in partial fulfillment of the requirements for the Degree of

Master of Science in Real Estate Development
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TABLE OF CONTENTS

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ABSTRACT

The nation is faced with a surplus of foreclosed residential property that lies vacant, incomplete or in dilapidated condition that is held by the federal government and banks. Many of these properties will be sold at prices far below their original value creating a new source of affordable rental housing if sold to the right developers.

The banking industry has recently taken more of an initiative to support affordable housing through federal mandates and community investment lending. In Massachusetts the banks have established loan consortiums for funding low- and moderate-income housing projects as a way of supplementing the dwindling federal and state funding programs.

The objective of this thesis was to identify the opportunities and obstacles that both nonprofit and private developers experienced in trying to create affordable rental housing from foreclosed property and how effective the bank sponsored loan pools were in funding this source of housing.

The obstacles encountered included conflicting regulatory limitations imposed on banks; rivalry between banks, the lack of a secondary market for permanent loans, and reluctance of sponsors to use the loan pools for bank-owned property. Nonprofit developers were at a further disadvantage, because of a lack of credibility, too little cash, and too much time needed to complete a sale. The research concludes with a series of recommendations to more effectively combine the resources and remove the obstacles identified.

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CHAPTER 1
INTRODUCTION

OVERVIEW

The real estate excesses of the 1980s have left this country with an unprecedented amount of surplus residential property. The problem is that it is in the hands of inappropriate owners, namely the federal government and banks that have been forced to foreclose on bad loans and are looking for ways to dispose of this unwanted real estate. Banks have had to create whole new ways of managing and disposing of what they call "other real estate owned" (OREO) property. At the same time, the banking industry has been bombarded with regulatory changes and tighter examination scrutiny brought on by the savings and loan crisis, making it more difficult to sell property at a loss or offer new loans for rental housing projects.

The glut of foreclosed property has lowered the price of existing housing to a level below its replacement cost making OREO property very attractive to developers of affordable housing. These developers must look to new resources for funding because of the cutbacks in federal and state housing programs that supported new construction and operation of low-income housing. In response to federal and state mandates and voluntary efforts on the part of some banks in Massachusetts, there are a number of new funding pools earmarked for affordable housing that could be used to support the development of foreclosed property for low- and moderate-income housing.

THE SCOPE OF THE STUDY

The primary purpose of this study is to look at the new role of the banking industry in providing affordable rental housing both as a resource for funding and as a supplier of OREO property. How to combine these resources and direct them to the groups that can make the best use of them for affordable housing will be examined. The Commonwealth of Massachusetts will be used as a focal point for exploring how the banks, developers, and housing agencies can work together to take advantage of this unique real estate opportunity. Massachusetts was selected because of its active history in committing programs and funds to affordable housing. A strong network of community development corporations, private developers, housing partnerships, and bank consortiums is already working on ways to pool resources to take advantage of the surplus housing stock. The variety of resources and the obstacles that developers are experiencing in Massachusetts could serve as an example for other regions of the country with similar housing needs.

As Richard W. Reynolds, the new President of the Boston Real Estate Board put it, "This is a rare opportunity...to make two problems - oversupply of condos and unfulfilled demand for housing - equal one mutual solution."[1]

This paper is presented in six chapters.

Chapter 1: Introduction

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1 *Boston Globe;* "The Industry Looks for Answers"; Boston, Mass.; January 26, 1991.

Chapter 2: Background A brief overview of the nature and magnitude of the current affordable housing dilemma including the changing role of the federal government in providing financing for housing, some background on how lenders got into the current situation, and the impact on Massachusetts.

Chapter 3: Opportunities A look at new funding resources supported by the banking community, both nationally and in Massachusetts, and the sources of foreclosed property that could be used for affordable rental housing.

Chapter 4: Obstacles Identification of problems experienced by people in the housing industry who are trying to create affordable rental housing including: regulatory restrictions for banks, access to property information about OREOs, financing problems, and the road blocks faced by nonprofit developers. This chapter also presents a project financial feasibility model for use in evaluating the case studies.

Chapter 5: Case Studies The experiences of both a nonprofit and for-profit developer who are trying to create affordable rental housing from OREO property.

Chapter 6: Analysis and Conclusions Some suggestions on how the process and the participants can be more effective in helping banks to make OREO property available for affordable housing.

RATIONALE FOR ANALYSIS

In looking at the new role of the banking industry, the thesis will focus on the problems encountered in the disposition and financing of foreclosed bank property as rental housing for low-income families in Massachusetts.

The surplus of single family residential real estate prompted a new marketing industry of real estate auctions and homebuyer shows for the Resolution Trust Corporation (RTC) as well as some bank-owned property, in an effort to reach the first-time home buyer. After a slow start, the banks and the RTC became more sophisticated in their marketing techniques and the vast amount of single family stock began to be sold directly to the consumer.

The multi-family inventory was a different story. It represented a far smaller share of any of the bank or government portfolios of foreclosed property. It included older rental apartments as well as new condominium projects that were incomplete or unsold. It ranged from two- to four-family structures to high rise projects. Inner city or remote locations, in combination with the other factors, made the projects difficult to market to inexperienced investors who were attracted to the auction and trade show forum. Furthermore the FDIC and RTC had complex restrictions and approval processes that seemed to make it difficult to make a deal. OREO property, on the other hand, while still in the hands of the local lenders, seemed more negotiable since the banks were anxious to get the property off their books and did not have to go through a lengthy approval process in Washington.

The need for rental housing for the low-income family was not being satisfied by the private or public sector. Multi-family rental housing experienced sharp declines in construction in the latter half of the 1980s because of the Tax Reform Act of 1986. Aging rental stock and the potential loss of low-and moderate-income rental housing, because of the expiring-use restrictions on Section 236 and 223 housing, will result in an even greater need for low- and moderate-income rental housing.

The banking community in Massachusetts had established a number of funding sources for supporting affordable housing that are highlighted in this study. One program was the Affordable Housing Program mandated by federal legislation through the Federal Home Loan Bank, while the other two were statewide funding pools formed voluntarily by banking consortiums. The Massachusetts Housing Partnership and the Massachusetts Housing Investment Corporation were nonprofit organizations comprised of bank members who loaned funds for low- and moderate-income housing projects. This new source of private financing was a reaction to the loss of public programs for affordable housing.

A number of for-profit and nonprofit housing developers and advocacy groups in Massachusetts understood the housing need and recognized the window of opportunity for obtaining permanent affordable rental housing from the surplus stock in the hands of the banks and the federal government. In contrast to the ownership market, where banks, the RTC and FDIC were dealing directly with the individual homebuyer, developers were needed to play an intermediary role in obtaining, rehabilitating, and managing affordable rental housing for the low-income household. In Massachusetts the network of local nonprofit developers and housing partnerships were uniquely positioned to take advantage of the situation because of their familiarity with the properties, the local lenders, and the local authorities.

This paper will explore how developers have been able to work with local banks to utilize OREO property as affordable rental housing for low-income households and specifically how effective the new bank sponsored loan pools have been in making the OREO projects feasible. The underlying premise is that the banks are in a position to control the supply of both the property and financial resources for affordable housing in order to satisfy a small part of the rental housing demand. Will this opportunity be realized and what are the obstacles interfering with its implementation?

METHODOLOGY

The methodology used for preparing this thesis relies on four major sources of information: 1) a literature review to establish the background context influencing the current situation; 2) program descriptions and material provided by the program sponsors; 3) interviews with housing agencies, bankers, developers and advocates; and 4) case studies of specific transactions.

The writing of this thesis occurred at an opportune time when many of the Massachusetts local community development corporations and technical assistance agencies were involved in the very issues discussed in this research. The newspapers were filled daily with stories related to bank foreclosures, second mortgage scandals, regulatory pressures, bank closures by the FDIC, and various innovative ways of selling the surplus property. The timeliness of the information made the interview method the most effective means of identifying both the opportunities and obstacles in obtaining bank-owned property for affordable rental housing. In particular, the work of both the Massachusetts Housing Partnership (MHP) and Citizens Housing and Planning Association (CHAPA) were most helpful in focusing the research on the particular problems in dealing with rental housing in today's banking climate.

Case studies were included to illustrate specific problems that the banks and the developers faced in working together and to highlight some of the obstacles they had to overcome to complete a transaction. There were very few completed transactions of OREO properties that had been sold for affordable rental housing due to the problems cited in this analysis. Instead of completed transactions I chose two representative examples of the experiences of both nonprofit developers and for-profit developers who were each trying to create affordable housing by working with the banks to obtain property and loans to finance the projects. The obstacles they experienced and the financial feasibility of the projects are analyzed in relation to the material discussed in this thesis.

As the reader may have already discovered, the discussion of any housing issue becomes an alphabet soup of program initials. A Glossary is included in the back of the report to use as a quick reference if you get lost in the letters.

CHAPTER 2
BACKGROUND

The purpose of this chapter is to give some perspective on the magnitude of the affordable housing dilemma brought on by the changes in housing policy and the economy during the 1980s. The federal government, once a key player in the production of housing, is now looking toward the private sector to be the provider. The lenders, who were so flush with capital during the 1980s, are mired in a sea of bad loans, foreclosures and insolvencies. The Commonwealth of Massachusetts, once the leader of affordable housing programs, is facing an economic crisis that has brought the state close to bankruptcy. This chapter will briefly describe these changes and the impact on the provision of affordable housing.

CHANGING ROLE OF THE FEDERAL GOVERNMENT IN HOUSING

Leadership from the Federal Government

Since the Housing Act of 1949 promised "a decent home and a suitable living environment for every American", the role of the federal government has evolved in response to the changing political, social and economic climate of this nation. The late 1960s and early 70s were guided by President Johnson's Committee on Urban Housing in its report, *A Decent Home (1968).* It placed the federal government in a strong leadership position with a goal to produce or rehabilitate six million housing units by 1978. While partnerships with private enterprise and local governments were mentioned, the brunt of the responsibility fell on the Federal Government as the "nation's houser of last resort". Members believed then that the housing problem could and should be resolved with federal dollars. [1]

By the 1980s and the Reagan Administration, there was a different philosophy and a new commission appointed by the President that produced a report in April, 1982. The Commission members characterized the programs emerging from the 1968 Housing Act as a failure, pointing to the federal government as a major cause of the problem rather than a source of the solution to the low-income housing dilemma.[2] They were particularly critical of rent supplements as a system of entitlements which had expanded out of control. They believed that grants should be limited to families of very low-incomes living in inadequate housing and paying too much of their income for housing. In their view, the housing crisis in 1981 rested in the financing system, which was cluttered with regulation and suffering from high interest rates and few tax incentives for multi-family production. The solution for the future was up to the "genius of the market economy to escape the fetters of public regulation and policies."[3]

The most recent federal housing report came out of the National Housing Task Force, *A Decent Place to Live, March 1988* [4] which was part of a Congressional effort, rather than a Presidential committee, to set a national housing agenda. The Report led to the National Housing Act of 1990. The Report was far less optimistic in terms of what had been accomplished and

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1 Keyes, Langley and Denise DiPasquale. "Housing Policy for the 1990's";*MIT Housing Policy Project*; Cambridge, Mass.: MIT Center for Real Estate Development; August 1988, p 3

2 Ibid, p 4.

3 Ibid, p 4.

4 "A Decent Place to Live: The Report of the National Housing Task Force"; James W. Rouse, Chairman; Washington DC; March 1988.

what was possible. Families seeking low-rent housing were increasing while the number of units available were shrinking because of a lack of private production of low-rent housing and the potential loss of public and private subsidized rental housing.[5]

The National Housing Task Force placed the federal government squarely in the middle of the two previous committees in terms of its leadership role in solving the low-income housing problem. The Report "emphasized the collaboration of the federal government with public, private, and nonprofit partners working at the state and municipal levels, entities already at work representing a new wave of initiative and resourcefulness in meeting our critical housing needs."[6] Federal funds and federal leadership should leverage other investment -- public and private -- in the housing markets of the nation.

National Affordable Housing Act

The National Affordable Housing Act (NAHA) created a new block grant program available to states and local communities called HOME. The funding level for 1992 was not set at the time of this writing but was projected to be $1 billion, down from the $3 billion recommended in the Act. The allocations were predicated on matching funds from the state. For Massachusetts that meant that the state would have to contribute $9 million in order to receive $26.7 million from the HOME program. As with most recent federal programs, there was too little money to spread over the ever growing need. At the $26.7 million funding level, the Commonwealth

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5 Keyes, p 5
6 Ibid, p 6

would be able to assist 1,869 units of housing based on an average of $14,286/unit. The funds could be used for the traditional housing programs giving priority to rent subsidies, moderate rehabilitation, substantial rehabilitation, and last priority - new construction. Other funds, under the HOPE program, were to be used for innovative programs like assisting in the sale of HUD housing to tenants, public housing modernization programs, the homeless, and other special needs groups. It was anticipated that Massachusetts would only be able to assist 300 of these kind of units under HOPE due to high costs estimated at $100,000/unit.[7]

In spite of the goal of a decent place to live, the level of funding for both new housing programs was too low to be effective and clearly took the federal government out of the role of producer of new rental housing because of the priority for rehabilitation and acquisition of existing public housing by tenant groups. So where was the federal support for the affordable housing developer (both private and nonprofit) looking for funding resources to create new rental housing? It was kept alive in the tax codes through Tax Credits for low-income rental housing.

Tax Credits

The Tax Reform Act of 1986 brought an end to the favorable tax treatment of rental housing that had been experienced under the Economic Recovery Tax Act of 1981. The rate of depreciation for rental property was changed from an accelerated schedule of 15-18 years to a straight line depreciation schedule with a tax life of 27.5 years. Passive investors (like limited partnerships which

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7 CHAPA Conference, Developing the Comprehensive Housing Affordability Strategy; Boston, Mass.; March 25, 1991.

were the dominant form of private investment in multi-family housing) were no longer able to deduct "passive losses" from real estate from their ordinary income.

The only tax vehicle left was the Low-Income Housing Tax Credit (LIHTC) which had become a substantial incentive for investment in low income housing. Investors in low-income rental housing projects received a nine percent (9%) credit for new construction or rehabilitation costs with the credit dropping to four percent (4%) if the project had federal subsidies or tax-exempt financing. LIHTCs were allocated by the state based on a maximum volume of credits available. Some states were reaching their volume caps on allocations as developers became more sophisticated and syndication pools, like the Local Initiative Support Coalition (LISC), became more marketable.[8]. For many low- and moderate-income housing projects, LIHTC were the only source of equity. Yet, despite the popularity of the LIHTC program, there was still insufficient permanent financing or rental subsidies to make many deals work, even with the LIHTC.[9] Developers still had to scramble to piece together a variety of sources to make a project pencil- out to be affordable to the low- and very low-income household.

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8 Ibid.

9 DiPasquale, Denise and Jean Cummings. "Accessing Capital Markets for Affordable Rental Housing", *Joint Center for Housing Studies*; Cambridge, Mass.: Harvard University; December 1990.

WHAT HAPPENED TO THE REAL ESTATE LENDERS?

A Brief Overview

The glut of residential property in the hands of government regulators and banks can be traced back to a series of events in the late 70s and early 80s that dramatically influenced real estate lending. John McMahan, CRE, a real estate advisor, gave a historical perspective on real estate capital markets that have influenced the problems that lenders and buyers are facing today.[10]

> *Inflation* - Double digit inflation in the mid-1970s caused savers to move out of the fixed-rate passbook accounts of savings and loan association or life insurance policies to seek higher yielding investments. The yields in the stock and bond markets were not much better so real estate became the preferred hedge against inflation. Pension funds were another big source of capital that began to flood the real estate markets.
>
> *Deregulation* - Congress deregulated financial institutions in 1981 allowing savings and loans to invest up to 10 percent of their portfolios in commercial property mortgages. Previously S&Ls were tied exclusively to residential mortgage lending with federal guarantees and strict underwriting guidelines. In an effort to compete with other investment vehicles, thrifts were free to turn to riskier but more lucrative commercial lending. Mortgages for investment property totaled $6.8 billion in 1981 which were largely in multi-family residential. By 1986, $39 billion was invested but mostly in commercial property mortgages. It was not just mortgages but equity participation in real estate deals that made the thrifts involvement even riskier.
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> *Absentee Ownership* - The ownership in real estate had become increasingly "absentee" in nature due to the institutionalization and

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10 McMahan, John. "The Real Estate Capital Market: Historical Perspectives, Emerging Trends, and Future Directions"; *Real Estate Issues;* Chicago, Ill.: National Association of Realtors; Fall/Winter 1987.

internationalization of the real estate capital markets. Even the small investor speculating in condominium units was an absentee owner relying on management firms to protect this investment.

Tax Legislation - Real estate has always received a modest tax subsidy through deductions of interest and depreciation, particularly for housing. It was not until 1981, when real estate received an unprecedented tax windfall from Congress, that things really took off. The combination of accelerated depreciation and exemption from "at risk rule" which limited deductions to the amount of funds invested, resulted in subsidies that made real estate far more attractive than other investments. More equity capital began pouring in before Congress enacted the Tax Reform Acts of 1986.

Over Supply - In the early 1980s there were high levels of S&L lending in the Southwest and South regions which were still enjoying the economic growth brought on by the earlier oil crisis. When states like Texas, Colorado, Arizona, and Oklahoma had gone bad the S&L activity began to wane, but the commercial banks started a new wave of lending in the Northeast. The longer processing time for zoning, financing and other approvals in the Northeast meant that projects were just beginning to be built when the tax laws of 1986 changed. The lag time in creating supply finally caught up just when demand was decreasing.

Real estate is a cyclical industry. When it started to turn down it fell fast from its own weight, from over supply created by the artificial nature of the demand and partially fed by financial institutions need to invest large sums of capital.

Lenders in New England

According to the Federal Reserve, the number of savings banks in New England, active in real estate, were unusually large relative to others states.

This was because of the large number of savings banks in New England overall, the fact that the authorizing statutes had been on the books for many years, and the real estate bull market in the 1980s.[11] The number of savings banks participating in real estate investment in New England increased from 21 percent in 1986 to 30 percent in 1988.

IMPACT ON MASSACHUSETTS

Housing Boom

Massachusetts was one of the regions in the country that experienced an unprecedented increase in single-family home prices. The Boston boom began in 1983 with the most rapid increases occurring between 1984 and 1985 when growth neared 40 percent per year.[12] The median price of existing single family homes in Boston rose from $82,000 in 1983 to $183,000 in 1988. During the same period rents were also rising sharply. In Boston, rents increased by 80 percent in nominal terms and 26 percent in real terms during the 1980-1988 period in comparison to national rents that rose 59 percent nominally and 11 percent in real terms.[13] While the lucky homeowners in Boston experienced a net worth increase of $100,000 on average, the region as a whole was becoming less affordable and more expensive to buy into.

> Homeowners experienced constantly declining real out-of-pocket housing cost, as fixed mortgage payments declined in real terms at the same time that housing prices were booming all around them. Renters, on the other

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11 Felgran, Steven D.. "Bank Participation in Real Estate: Conduct, Risk and Regulation"; *New England Economic Review;* Boston, Mass.: Federal Reserve Bank of Boston; Nov./Dec. 1988, p 61.

12 Case, Karl and Leah Cook. "The Distributional Effects of Housing Price Booms: Winners and Losers in Boston, 1980-88"; *New England Review;* Boston, Mass.: Federal Reserve Bank of Boston; May/June 1989, p 3, 4

13 Ibid., p 4

> hand, experienced rising real housing costs and watched the probability of owning decline.[14]

Housing for the low-income household is usually dependent on some kind of public subsidy program or the "filtering process". The filtering process refers to the phenomenon of high-income households moving up to more expensive housing, leaving behind lower cost housing for the bottom tier households. That process was not working in Massachusetts during the 1980s. Rapid increases in land prices made lower-income rental housing construction prohibitive. Furthermore, the frenzy for buying any kind of housing prompted speculators to convert rental properties to condominiums which reduced vacancy rates and increased rents for apartments and the condominiums that were turned into rentals by investors.[15] It was the time of the "Massachusetts Miracle" and it seemed that there was no end in sight, but even economists can be wrong. Case and Shiller, economists at the Federal Reserve, anticipated in 1988 that prices were only leveling:

> While home prices stopped rising in 1987, it is unlikely that they will fall back to earlier levels. Evidence suggests that in the absence of real economic collapse, housing prices do not fall at the end of booms, they simply stop rising.[16]

The Bubble Bursts

The Miracle did end and Massachusetts fell victim to the same over supply of housing that other regions were experiencing. In Massachusetts, however, there was a missing ingredient on the demand side that would have major implications on the severity of the recession to come -- population growth was extremely slow. The supply increase was spurred by escalating land and

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14 Ibid., p 3
15 Ibid., p 11
16 Ibid., p 4

home prices as the building boom caught up with the price boom at the same time that the economy began its slow down.[17]. Speculation, in the wake of falling rents and erroding house values that made assets worth less than current mortgages, meant people were defaulting on loans and abandoning property. It left thrifts, banks, and the government with an unprecedented amount of foreclosed property.

According to *Banker & Tradesman*, in the Spring of 1991, the FDIC held $145 million in bank-owned property in Massachusetts.[18] During 1990 there were 11,496 foreclosures, triple the rate of 1989, and ten times the "normal" condition. As a comparison, there were only 400 foreclosures in 1985. By summer of 1991 there were 13,420 foreclosures that year alone.

The size of the problem was hard to pin down. One estimate of Veribanc Inc., a nationwide bank rating service, estimated that Massachusetts had $6.53 billion in distressed commercial and residential real estate loans which was almost 11 percent of the $60 billion in mortgages in the state.[19] The Federal Reserve Bank estimated that bank-owned real estate in New England was more than $5.7 billion or two percent of total bank assets.[20] Nationally such properties make up only about eight-tenths of one percent (.8%) of assets.[21] A study of 12,795 commercial banks in the nation revealed that 11 of the banks that posed the greatest threat to the federal deposit insurance fund were based

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17 Case, Karl E. "Bank Regulation, Real Estate and the Massachusetts Economy"; Massachusetts Bankers Association; Boston, Mass.; June 1990.

18 Springsteel, Ian. "Will FDIC in New England Live Up to Its Reputation or Overcome It?"; *Banker & Tradesman;* Boston, Mass.; May 8, 1991.

19 "OREOs: Are There Really Deals Worth Grabbing?"; *Purchase Power,* Massachusetts Homebuyers Club; Boston, Mass.; Spring 1991.

20 "Orphaned Property"; *Boston Globe;* Boston, Mass.; July 21, 1991; p A49.

21 Ibid.

in New England with Boston First Mutual topping the list (it was taken over by the FDIC on June 27, 1991) and Bank of New England ranking third. [22] Estimates of the FDIC bailouts nationwide totaled $11.6 billion, which exceeded the current estimated value of the deposit fund by more than $2 billion, confirming the General Accounting Office's findings that the bank insurance fund was de facto insolvent.[23]

While the bubble had burst on inflating housing prices and had caused the foreclosure of countless properties, there was some ray of hope for the prospect of affordable housing in Massachusetts as housing price levels sought an equilibrium point. The loss of jobs and the lack of in-migration into Massachusetts had further caused housing and rental prices to fall making the region more affordable, relative to other areas of the country, but it also had an impact on the state's economy. Dwindling incomes and consumer spending had left the state treasury facing unprecedented budget deficits. The innovative programs for health care, education and housing that were freely funded in the 1980s, when revenue was flowing-in, were dismantled as the state tried to balance the budget with no new taxes.

The Need for Affordable Housing

The need for affordable housing in Massachusetts was most recently documented in the "Comprehensive Housing Affordability Strategy " (CHAS) prepared by EOCD to apply for federal funds under the National Affordable Housing Act. Census data for 1990 was not available so the information in

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22 "Eleven New England Banks a Threat to FDIC"; *Boston Globe;* Boston, Mass.; May 8, 1991.

23 Ibid.

the CHAS relied on a variety of other sources. A 1985 Amercian Housing Survey revealed that there were 150,000 low- and moderate- income households in Massachusetts who paid more than 50 percent of their income for housing.[24] There were 161,000 elderly who were income eligible for state public housing programs inspite of the fact that they owned their own homes. They were house rich and cash poor. The vacancy rate for multi-family housing in 1989 was at 1.8 percent. The median gross rent in the state was $650/month but in Boston it was 15 percent higher at $725/month.[25]

During the 1980s, Massachusetts had been one of the leaders in the nation in creating innovative programs for affordable housing. The 1989 Mission and Goals Statement for The State's Executive Office of Communities and Development (EOCD) described the situation:

> The number of state programs has burgeoned through the 1980s: EOCD currently manages some 75 different programs that fund municipal government, local housing authorities, community action agencies, and a variety of neighborhood-based, nonprofit planning and development organizations. No other state builds public housing, pays rent subsidies for low-income tenants, or offers as many incentives to plan and manage growth in urban, suburban, and rural communities.... Massachusetts commitment to housing and community development is a source of pride and energy.[26]

The cornerstones of the Massachusetts housing programs, that tried to fill the gap left by the federal government were slashed in 1991. In the current Budget the Chapter 707 program for Rental Assistance was cut 35 percent, funded only at a level that would support existing projects with financing

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24 Massachusetts Comprehensive Housing Affordability Strategy for FY 1991"; EOCD; Boston, Mass.; April 1, 1991.

25 Ibid.

26 "Executive Office of Community Development: FY89 Mission and Goals"; Boston, Mass.; p 1.

commitments, like tax credits or MHFA issued bonds, that depended on maintaining affordability for low-income households. In addition, the tenant's share of the rent was increased from 25 percent of income to 30 percent. There was no longer funding to subsidize lower rents for new construction. EOCD was threatened to be dismantled and put under the Department of Human Services. That threat did not materialize in the 1991-92 Budget but the housing providers of Massachusetts clearly got the message that they had to look elsewhere for new ways of creating affordable housing.

CHAPTER 3
OPPORTUNITIES: NEW SOURCES OF FUNDS AND PROPERTIES

The dilemmas brought on by the down turn in the real estate industry, described in Chapter 2, make things look pretty hopeless for affordable housing, but there are some opportunities. The purpose of this chapter is to describe some of the opportunities in the sources of funding and property that have resulted from the changes in the banking industry. Some of the opportunities are a direct result of federal legislation mandating that lenders create a pool of funds or make property available for affordable housing. Others, like the Massachusetts Housing Investment Corporation, were the result of lenders working together to voluntarily create a funding pool.

The chapter is organized into two parts. The first part of the chapter focuses on federal initiatives directing lenders to provide funding sources for affordable housing and explains some of the Massachusetts programs that were initiated by the state and local lenders. The Massachusetts banks have been particularly active in affordable housing and provide lessons that can be transferred to lenders in other parts of the county who want to become more involved in community investment programs. The second part describes three sources of foreclosed property available to developers, namely OREO, the RTC, and the FDIC.

NEW SOURCES OF FUNDING

FIRREA

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 was enacted by Congress in response to the thrift crisis and general lending problems relating to real estate. The purpose of FIRREA was the reorganization of the structures and standards of thrift institutions, new restrictions on the activities of thrift institutions, and an increase in the regulatory and enforcement powers of the Federal Deposit Insurance Corporation (FDIC).[1] While the thrift crisis precipitated the enactment of FIRREA, the intent of Congress was to improve not only the regulation of federally insured savings & loan associations but the commercial banks as well. Another fundamental purpose was to promote a safe and stable system of affordable housing finance and to get the S&L associations out of risky investments through stricter capital requirements, accounting methods, reporting techniques, and standards of supervision.[2]

Part of the FIRREA restructuring was the abolishment of the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Home Loan Bank Board (FHLBB) coupled with the creation of the Office of Thrift Supervision (OTS) and the Resolution Trust Corporation (RTC). The RTC was given jurisdiction and authority over all institutions that were insured by FSLIC and entered into conservatorship or receivership between January 1, 1989 and August 9, 1992.[3]

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1 Stuart M. Saft, "The Basics of FIRREA and the Resolution Trust Corporation", The Real Estate Finance Journal; Winter 1991; p 49.

2 Ibid, p 49.

3 Ibid, p 49.

FIRREA expanded and strengthened the FDIC's examination and enforcement authority and gave it jurisdiction over both commercial banking institutions and S&L associations.

RTC

Purpose and Background

The duties of the RTC were: to manage and resolve the affairs of failed institutions; to maximize the return on the sale and disposition of institutions; to minimize the impact on local real estate and financial markets in disposing of real estate held by failed institutions; and to utilize its funds to minimize the loss from failed institutions.[4] As manager to the RTC, the FDIC had the responsibility of day-to day operations, providing personnel, facilities, and services to RTC as needed.

The RTC was specifically required to provide home ownership and rental housing opportunities for very-low-income, lower-income, and moderate-income families. Homes that qualified had to be appraised at values not exceeding $67,500 for single family homes and $28,032-$58,392 for units in multi-family properties. One of the disposition objectives of FIRREA was to maximize the preservation of residential real property for low- and moderate-income individuals; however, there were special rules governing the sale of real-property in distressed areas. RTC could not sell for less than 95 percent of

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4 Ibid, p 50.

market value without FDIC authorization. This was in conflict with the other objectives of affordability for low-income households.

New funding legislation sponsored by Henry Gonzalez, D-Texas, Chairman of the House Banking Committee, solved some of the conflict and made more of the RTC inventory available to low- and moderate-income families. The changes helped the RTC to more quickly dispose of its large inventory of single family homes in depressed real estate markets. The result increased the affordable housing inventory by about 7,100 homes.[5] The new legislation loosened some of the provisions for disposition so that properties could be sold while in conservatorship as well as receivership. It also deleted the requirement for a minimum sales price for RTC-held property so that the Corporation could sell eligible single family property to qualifying households, nonprofit organizations, and public agencies without regard to a minimum purchase price.[6]

Implementation

By Spring 1991, the RTC owned approximately 18,000 properties nationwide that fit the affordable housing category[7]. The agency had sold approximately 1,500 home to low- and moderate-income families in the first two years of its creation. Another 2,000-3,000 homes were classified as "not economically viable to keep". Officials at RTC had indicated that these homes would be given away to low- and moderate-income families or to nonprofit housing

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5 CRA/HMD Update; Vol. II, No. 4; April 1991; p 11
6 Ibid, p 12
7 Ibid, p 12

groups.[8] To help facilitate sales, approximately $250 million was available in financing for the Affordable Housing Disposition Program.

Although the size of the New England portfolio of affordable housing properties was relatively small, compared to the holdings in the southwest, the RTC was more successful in disposing of the property through the auction process. On June 21-24, an "Absolute Affordable Housing Auction" was held for over 250 properties in New England (77% in Massachusetts) comprising mostly condos, houses, land, and a few apartment projects. The RTC sold 218 pieces of property and raised $9 million with an average price of $41,000.[9] RTC claimed that 45 percent of the buyers earned $25,000 or less and 60 percent of the buyers in Boston were minorities.

One of the biggest problems that the nonprofit organizations had with RTC was the limited supply of rental housing for sale and the inability of the nonprofit developer to package what little was available because of time and financial constraints. As of April 30, 1991 there were 489 complexes eligible for the Affordable Housing Disposition Program, 289 (59%) were in Texas and less than 87 were outside Arizona, Colorado, Florida, Louisiana or Oklahoma.[10] There were no specific figures for New England.

The New York Times exposed an alleged abuse of the Affordable Housing Program where investors were able to buy the best apartment projects as a package with other less desirable complexes. In particular, General Electric

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8 Ibid, p 12

9 "Trouble at the Finish Line"; *Boston Globe;* June 30, 1991; p 65.

10 "Housing Earmarked for the Poor is Enriching Big Investors Instead", *New York Times;* June 27, 1991.

purchased a number of apartment projects for $75 million with the intent of setting aside 35 percent of the units purchased for low-income families, in compliance with the Affordable Housing Disposition Program. The proposal was to use the less desirable complexes for the set-aside units, thus segregating the low-income tenants and not mixing them in all the projects as intended by the regulations. The big corporations with easier access to cash had been the only ones able to buy in bulk thereby getting the pick of the best projects. RTC was working with Fannie Mae to develop a financing program that would help the nonprofit groups compete more effectively in bidding for multi-family properties. [11] The ability of a developer to pay cash for distressed property and thereby gain a competitive advantage is a theme that runs throughout this research in looking at RTC, FDIC and OREO property

FHFB

Purpose and Background

The Federal Housing Finance Board (FHFB), is the regulator of the Federal Home Loan Bank System, and responsible for the implementation of the Affordable Housing Program (AHP) authorized under FIRREA. Under the terms of the Act, the 12 district banks must use a prescribed portion of their income to make below-interest rate advances to member institutions. The advances were used by thrifts to make below-market rate mortgage loans to low- and moderate-income home-buyers. The FHFB anticipated that the affordable housing program funds would be used by developers in conjunction with other FHLBank programs such as the Community

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11 Ibid.

Investment Program and the federal Low-Income Housing Tax Credit as well as other state and local funding sources.[12] Developers of affordable housing have long recognized the need for a variety of funding sources to make a low-income project viable. A combination of low interest permanent financing, federal grants, rental subsidies, and tax credits on equity investment were all part of the package. David Parish of the FHLBank of Boston pointed out that AHP alone could not make a marginal low-income project work but it could be the added boost to make more units affordable or give a deeper discount to reach very low-income families.[13]

Projects were selected on a twice-yearly competition held at the FHLBank district level. Applications were evaluated based on criteria and objectives in the regulations that reflected the broad goal of "reaching the targeted household, providing maximum assistance per subsidy dollar, and encouraging innovation, community involvement, and community stability."[14]

The FHLB listed seven priorities for project financing:

1. The purchase, construction and rehabilitation of owner-occupied homes for very low-, low- and moderate-income households.

2. The purchase, construction and rehabilitation of rental housing with at least 20 percent of the units occupied by very low-income households.

3. The purchase or rehabilitation of housing owned or held by the federal government including HUD or the RTC.

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12 CRA/HMD Update; Vol. 1, No. 2; April 1990; p 7

13 Parish, David, Vice President, Federal Home Loan Bank of Boston; Conference All the Way to the Bank; Massachusetts Housing Partnership; Boston, Mass.; July 18, 1991

14 CRA/HMD Update; April 1990; p 8.

4. The purchase, construction and rehabilitation of housing, sponsored by non-profit organizations, a state or local government, or a local or state housing authority.
5. Resident management, urban homesteading, and similar programs.
6. Fair housing.
7. Permanent housing for the homeless.[15]

Projects were grouped as to whether they met three or more criteria and then rated under a complicated 100-point scoring system.

Program Mechanics

The FHLBanks set aside contributions to the affordable housing program to create a minimum funding pool nationally of $50 million for the program. An individual bank's contribution beginning in 1990 through 1993, was based on five percent (5%) of the preceding year's net income or a pro-rated sum that would enable the aggregate contributions of all the banks to meet the $50 million minimum. In 1994, the contribution would rise to six percent (6%), with a minimum of $75 million, and in 1995 it jumped to a ten percent contribution with a minimum of $100 million.[16] The FHFB collected a total of $78,783,000 nationwide in 1990 but anticipated as much as a 10-20 percent reduction in funds in 1991.

AHP loans to member financial institutions were priced below the cost of funds for FHLBank Rates were specific to each project and varied from one year to a 20 year term. AHP loans could be written down to zero interest rate if necessary using the AHP funds set-aside from its net earnings to subsidize

15 Ibid, p 8.
16 CRA/HMD Update; Vol. 1, No. 1; March 1990; p 14.

the interest rates. Member banks structured project financing, taking into account all sources of funds to establish the AHP rate to make the project feasible.[17]

New England FHLBank

The FHLBank of Boston contributed $12.8 million to create 37 developments of 1,215 affordable housing units under the Affordable Housing Program as of June 1991. There have been three funding rounds since the program began in 1990. The first round funded projects that had been caught in the pipeline of other funding sources that were no longer available. The second and third rounds more closely reflected the specifics of this program. The program has been very successful in funding projects for families at 50% of median income.with 70 percent of the 1990 projects and 94 percent of the 1991 projects reaching the very low-income category.[18] Eleven percent of the projects have been for homeownership. Funding carries withit a 40 year restriction to maintain affordability.

FHLBank of Boston had a fourteen member Advisory Council with two representatives from each of the New England states and two members from the state housing finance agencies involved in providing or promoting low- and moderate-income housing. They met regularly with the Directors of the FHLBank of Boston to advise them of housing needs and utilization of AHP advances to meet these needs. Allocations for AHP were made at the local level subject to the approval of the FHFB in Washington.

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17 Federal Home Loan Bank of Boston, "Banking Services for Banks"; Boston, Mass.; 1991.

18 Parish; July 18, 1991

In addition to AHP, the FHLBank of Boston had two additional programs to fund affordable housing and community investment initiatives called Community Investment Program (CIP) and New England Housing Fund (NEHF) Program. Both programs were continuously available sources of funds that were offered at reduced rates but with no subsidy involved. CIP was targeted at households earning less than 115 percent of median income and NEHF targeted families below 140 percent. In 1990 the bank approved over $60 million in CIP advances and over $50 million in NEHF advances.[19]

MHIC

Purpose and Background

The Massachusetts Housing Investment Corporation (MHIC) was incorporated July 1, 1990 with the mission of improving and expanding financing of affordable housing throughout Massachusetts. The three primary goals were: 1) the creation of a multi-bank loan pool; 2) the standardization of tax credit equity investments; and 3) the provision of long-term financing for affordable housing.[20]

The MHIC is part of the Massachusetts Bankers Association five-year Community Investment Program. The program was the result of a series of task force meetings in the summer and fall of 1989 that dealt with many lending problems. One of the task forces, led by Dick Driscoll of the Bank of

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19 Federal Home Loan Bank of Boston, "Annual Report 1990"; Boston, Mass.; 1990.

20 Massachusetts Housing Investment Corporation; Background Material; Boston, Mass.; May 31, 1991

New England, identified a number of problems in obtaining loans for affordable housing production including: 1) high turnover of bank lending officers knowledgeable about government finance programs; 2) convincing larger banks to consider smaller loans; and 3) a need for better understanding of bank lending policies and parameters.

In response, the MBA and community participants agreed on a number of new initiatives regarding community banking services and credit needs including the creation of a $100 million loan pool for affordable housing and a $100 million program for tax credit equity financing.

Program Mechanics

Loan Pool - The loan pool provided short-term new construction or rehabilitation loans for affordable housing on a statewide basis. The bank loan pool of $100 million was a revolving account to provide continuing availability of funds for affordable housing. Loans were targeted at amounts under $5 million and supplemented other available financing. Eligible projects had to make at least 50 percent of the units affordable to low-income households (below 80% of median) and at least 25 percent of the units had to be restricted to long term affordability for at least 15 years. Interest rates were set at the prime rate plus 50 basis points. Credit approval was through a loan committee, composed of individuals designated by the banks.

Tax Credit Equity Investing - The complexity of working with tax credit equity investments led the participating banks to agree to standardize: the analytical approach to valuing tax credits; the requirements for projection of financial results of the projects; and the legal and tax accounting support required to close transactions. MHIC's role was to coordinate the standardization and marketing of the credits to participating banks. An equity pool was not anticipated because of the administrative and underwriting burdens.

Long Term Financing - Due to the limited amount of available funds , MHIC did not want to use its funds for long-term financing but was willing to work with a number of other funding sources that could provide permanent financing for rental housing projects including: Massachusetts Housing Finance Agency (MHFA), the Massachusetts Government Land Bank; Fannie Mae and Freddie Mac; and other institutional investors like insurance companies, and pension funds.[21]

Implementation

By June of 1991 the MHIC loan pool was capitalized at $48,500,000 from 17 member banks. There were approximately 1,228 units in 32 projects in the pipeline for ownership, rental and cooperative housing throughout the state mostly sponsored by local community development corporations. A total of $8.92 million in loans had closed on 223 units in the loan pool while the tax credit pool had committed $51.7 million and had completed investments of $9.7 million in 260 units to date.[22] Some of the delays had to do with starting up the corporation and failure of city and state officials to deliver promised loan subsidies, according to Joe Flatley, the President of MHIC. [23] Now that

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21 Ibid.

22 "Doubts Cast on 1990 Plan for Reinvesting", *Boston Globe*; Boston, Mass.; June 30, 1991.

23 Ibid.

the program was fully operational they anticipated completing the loans in the pipeline more quickly. [24]

The other fundamental problem was the lack of permanent financing. Flatley indicated that they were working to develop a permanent financing package with standardized underwriting criteria that could be sold to institutional investors such as pension funds and secondary markets.

Pension funds, particularly were seen as a new resource of first mortgage financing for rental housing. MHIC had a Permanent Financing Task Force on which Amy Anthony served. Amy Anthony, former Secretary of EOCD in Massachusetts, was working for Aldrich, Eastman, and Waltch (AEW), a pension fund real estate advisory firm in Boston, to generate a fund targeted at economic development and affordable housing products.[25] Similar funds in New York and Connecticut were in the early stages of implementation. Public employee pension funds were the sponsors most likely to try the new concept providing the returns were high enough relative to the risks. Pension funds, investing in real estate, did not generally participate in deals below $10 million and preferred even larger projects. Projects for multi-family housing were much smaller than that which meant that projects needed to be aggregated in a pool large enough to warrant their investment. Standardization of the financing package, pre-screening developers, and tight underwriting criteria were a key part of the packaging of loans to sell to

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24 Interview with Joe Flatley, President of Massachusetts Investment Corporation; Boston, Mass.; July 26, 1991.

25 Telephone interview with Amy Anthony, AEW; Boston, Mass.; July 17, 1991.

institutional buyers. The financing model developed by MHIC was an attempt at creating such a package.

MHP

Purpose and Background

The Massachusetts Housing Partnership (MHP) was established in 1985 by Governor Dukakis under EOCD for the purpose of providing technical assistance and financial support to a developing network of 200 local housing partnerships throughout Massachusetts who were involved in acquiring, preserving, or developing affordable housing. The agency became a separate corporation in July 1990. MHP was governed by a 40-member board which included the Governor, the Secretary of EOCD, and state leaders in government, business, finance, low-income advocacy, and private and nonprofit development.

Financing and administrative support for MHP was provided by the MHP Fund, a corporation established by the state legislators using a $35 million trust fund provided by the State's savings and cooperative banks. It was governed by a seven-member board with representation from the banking community who administered grants, loans and technical assistance. Most of the funds had been used up during the five years of operation with a remainder of only $4.5 million in reserves by July 1991. The real funding potential however, was with the Interstate Banking Act, adopted by the Commonwealth of Massachusetts under Chapter 102 of the Acts of 1990. Chapter 102 required that out-of-state banks and bank holding companies, which acquired a Massachusetts bank, had to make nine-tenths of one percent

(.9%) of the acquired bank's assets in the Commonwealth available for use by the MHP Fund to support low- and moderate-income housing. The acquisition of Bank of New England by Fleet/Norstar of Rhode Island was expected to result in making at least $63 million available to MHP by September 1991. A similar bank-purchase by the Royal Bank of Scotland had already made $2.5 million available to the loan pool. This new pool of funds (and the possibility of more as banks continued to fail) would dramatically change the role of MHP as a new provider of financing for affordable housing.

Program Mechanics

MHP performed two primary functions: 1) support for local housing partnerships and 2) financial assistance.[26]

Support for Local Housing Partnerships - MHP had a lead role in acting as an intermediary between bankers, local officials and community organizations to establish coalitions for developing new private lending products to increase the supply of affordable housing. Successful ventures were underway in New Bedford, Fitchburg, Cape Cod, and Northhampton.

MHP, in conjunction with the housing partnership in Webster, was able to work with the local lender to convert a foreclosed housing project of 18 condominium units into affordable housing for qualifying first time home-buyers. The homes ranged in price from $62,000- $82,000. In addition to the discount price on the property, the bank provided an 8.5% fixed rate mortgage

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26 "Massachusetts Housing Partnership Fund Guidelines"; MHP; Boston, Mass.; February 1991.

with no points. MHP's expertise in negotiations with banks and ability to expedite the loan process was helpful to the Webster project.

Financial Assistance - Under the original $35 million trust fund, initiated by the state, MHP administered three revolving loan funds that provided professional service, to local housing partnerships, municipalities, nonprofit organizations and developers.

- Housing Venture Fund: Seed money up to $50,000 was made available for innovative projects that demonstrate new or better ways of developing affordable housing with minimal public assistance. Loans from the Fund were targeted to four categories of projects: leveraging private financing; utilizing unsold housing stock; preventing urban disinvestment; and preserving existing affordable housing.

- Early Project Assistance: Front-end pre-development loans of up to $50,000 were provided to specific development projects supported by local partnerships. Funds could be used for a range of mortgagable activities, including: architectural/engineering costs, legal assistance, finance packaging, permit and application fees, proforma preparation, site option money, and more.

- Short Term Technical Assistance: Immediate assistance up to $3,000 in technical assistance was given to communities beginning to explore the feasibility of a particular housing project or program. MHP worked directly with the consultants for services relating to: appraisals, bank negotiations, proformas, site evaluations, preliminary architectural or engineering services, and more.

Interstate Banking Funds - Substantial new resources became available to MHP through the Nationwide Interstate Banking Act enacted by the Massachusetts legislature in 1990. The general purpose of the MHP Fund was "to assist persons with low- and moderate-incomes to rent or purchase affordable housing in the private market and to expand the supply of affordable housing in the Commonwealth."[27] Households with incomes below 80 percent of median would be targeted and at least 25 percent of those units should be rented to households below 50 percent of median.

At the time of this writing the MHP Board was still considering a number of options for using the funds including permanent loans for rental housing, acquisition loans for FDIC-owned real estate, and soft second loans for first-time homebuyers.[28] The first two options dealt directly with the issues addressed in this thesis and are discussed further.

> *Rental Housing:* MHP staff recognized the need for permanent financing for rental housing including: projects in the pipeline with funding commitments from federal resources or other programs and new rental projects that could no longer depend on state operating subsidies or project-based rental assistance. Feasibility of projects depended on low acquisition costs through the purchase of bank- or FDIC-owned properties and a layered funding model further described in Chapter 4. Coordination among the key participants was essential in minimizing complexity and reducing transaction costs. The funds could be used as 30 year mortgages at an interest rate based on the bank's cost of funds plus 150 basis points. Loans at this time would have been in the 8.5 - 9 percent range.
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> *Short-Term Financing for FDIC-Owned Real Estate:* MHP identified a significant resource of vacant housing stock owned or controlled by banks and by bank liquidators such as the FDIC. The nature of the disposition of this property did not typically give the developer the usual option period to assemble plans and arrange financing. Foreclosure auctions required substantial earnest money up front and a cash closing weeks after an offer was accepted. The FDIC and other banks were interested in cash offers and would not provide options or

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27 "Financing by the Massachusetts Housing Partnership Fund Pursuant to Chapter 102 - Preliminary Recommendations"; MHP; Boston, Mass.; June 1991.

28 Ibid.

> otherwise take properties off the market. Furthermore it was difficult to find a conventional lender willing to finance the acquisition of these properties. It was proposed that the Chapter 102 funds be made available to for-profit and nonprofit developers to finance the acquisition of bank-owned property that met the criteria [29]

According to Carl White at MHP, the FDIC was a major source of property that they were targeting because of the agency's sense of cooperation and willingness to lower the price to sell the properties. There seemed to be a greater need for MHP funding for those transactions because the FDIC did not have its own financing. He believed that banks had more flexibility to refinance their own OREO property and should do so.[30] Whether the banks were meeting this assumed obligation is discussed further in Chapter 4.

SUMMARY OF LOAN POOLS

	AHP	*MHIC*	*MHP*
Fund Goal	% of yearly income $5.1 million in 1991	$100 million over 5 years	$65.5 million over 10 years
Allocations to Date	$12.8 million	$48.5 million	Funding will start in Fall 1991
Method of Allocation	2 x a year competition	On going	On going
Target Income Group	Below 80% of median	Below 80% of median	Below 80% of median
Uses			
Permanent Loans	Variable interest rate	No	Developing program
Short Term Loans	Variable interest rate	Prime +1.5 pt , Max 3 years	Cost of funds + 150 basis pts.
Grants	Yes	No	No
Homeownership	Yes	Yes	No
Technical Assistance	No	No	No
Tax Credits	No	$100 million	No
Loans for Seed Money	No	No	No

29 Ibid

30 Interview with Carl White, Director of Program and Policy Development, Massachusetts Housing Partnership; Boston, June 27, 1991

SOURCES OF PROPERTY

The second important ingredient in creating affordable housing is controlling the cost of the physical project. In the case of new construction, projects often depend on inexpensive (or donated land), smaller housing units with minimal amenities to control square footage costs, reduced developer fees for private developers, and/or reduced permit fees if an nonprofit developer is involved. Purchasing existing housing that is lower in cost because it needs rehabilitation or is located in a less desirable neighborhood is another way of obtaining affordable housing. The plight of the banks and the government holding foreclosed property fits the second category. For the first time there was a glut of housing in the marketplace that inappropriate owners wanted to sell that was below replacement costs for new construction. The condition and type of housing ran the gamut from unfinished, high-end condos to rundown three-decker walkups.which meant that the developer of affordable housing had a good chance of finding something suitable to her needs. Where were the sources of property and how was the developer able to gain access to those sources will be discussed next.

OREO

Bank Lists

Bank-owned property or other real estate owned (OREO) is property acquired by a lender through foreclosure and held in inventory until sold. Each bank kept its own portfolio of OREO property and was often reluctant to give out statistical information on its size and composition, which made it difficult to get any firm data on the amount of housing that may be available for affordable rental units. Massachusetts Bankers Association estimated that there was $2.7 billion in OREO property among its 320 member banks.[31]

Developers seeking units had to deal with each lender separately to obtain a listing. A few were willing to release a list but most suggested that the potential buyer specify what they wanted in writing. According to Kate Armstrong at Shawmut Bank, "There is no magic list. It is better to define what you are looking for by area, or type of product rather than use a shot gun approach. The more specific the request the better."[32]

Banks apparently did not share information about their listings and in fact seemed to keep it a secret, given the precarious state of survival of some of the banks and the fierce competition to sell properties to the few buyers in the market. The good properties were not a problem to sell, particularly in the 1-4 unit houses and condominium category that Armstrong's group handled. There were many renter occupants who wanted to purchase their units, contractors and handymen looking for a good "fixer-upper", and some first-time homebuyers. The problem was with the dilapidated units in bad locations that were boarded up or abandoned and further compounded by environmental liabilities.

Brokers

Given the size of some of the OREO portfolios, a few banks had resorted to broker services to list property and handle the initial transaction work. The

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31 Telephone interview with Martha Ikerd, Director of Research, Massachusetts Bankers Association; Boston, Mass.; July 5, 1991

32 Kate Armstrong, Vice President Shawmut Bank, presentation at Conference Beyond the Boom; MHP; Boston, Mass.; May 31, 1991

use of brokers was a relatively new phenomena. Bank of New England/Fleet had a wholly owned subsidiary called Recoll which managed the OREO property. Some of the assets were handled in-house while others would go through brokers. More detail on how banks managed OREO is discussed in Chapter 4 , *Where to Start.*

Listing Services

MHP attempted to get a handle on bank-owned property by analyzing the information in two listing services: "The Lenders Property List", prepared by Massachusetts Equity Corporation and "The Source", from First Manchester Group. Both sources were similar to a multiple listing service, updated monthly, and gave basic property information, location and a picture. Interested persons could subscribe to the service. MHP compiled data on 1,386 projects listed from the two services and found that 54 percent were listed at under $100,000, with 17 percent under $50,000. The average size for units priced between $51-100,000 was 902 square feet, which was larger than many people anticipated given the price of the units.[33] Information on actual apartments versus condominiums was not available and not analyzed for this study.

Innovative Methods

Unusual steps were taken by banks desperate to unload the large quantity of property in their inventories, particularly single family homes and condominiums. The First Manchester Group was a marketing firm that organized one of the first bank-owned property shows in New England in

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33 Housing Conference; Beyond the Boom; Massachusetts Housing Partnership; Boston, Mass.; May 31, 1991.

January 1991. The property expo was held at the Hynes Auditorium and attracted over 30,000 people. The show concept was used by other promoters and generated a lot of interest but few sales. Kate Armstrong of Shawmut Bank, said that they had a lot of property available at the January Show but no sales were transacted as the result of their participation.[34] First Manchester had decided to move away from the show forum because of the chaos caused by the massive crowds, according to president Timothy Harrington.[35] Their newest concept was a Showroom store front where people could drop-in and browse through a computer-aided multiple listing of properties.[36] For a one-time fee the buyer worked with a service agent and received pertinent data regarding location, size, price and financing options. If a property was appealing they could "drive-by" before actively pursuing an inspection with a broker or bank-appointed individual. Both residential and commercial properties were listed. Manchester was the marketing agent acting as a liaison between the 50 banks and the perspective buyers. They did not broker the transaction. The listing banks paid a fee to Manchester depending on the number of assets listed. The names of the participating banks were not publicized at The Showroom.

RTC

While the disposition of the Resolution Trust Corporation (RTC) property is beyond the scope of this study, it was still an important resource of affordable housing directly resulting from the demise of the banking industry. The RTC

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34 Armstrong, July 1, 1991.

35 "The Lure of Bank-Owned Property"; *Boston Globe*;Boston;, Mass.; April 20, 1991.

36 Site Visit; The Showroom of Bank-owned Real Estate; 282 Congress St., Boston, Mass.; First Manchester Group; June 18, 1991.

had the monumental task of disposing of billions of dollars of real estate across the country from the failed savings and loans that had been taken over. Over 577 institutions had been taken over under FIRREA by Spring of 1991. According to Ross Ford, Director of the Northeast Satellite, 75 percent of the 40,000 REO properties nationally were single family homes but it only represented six percent (6%) of the value of all of the assets. Most of the property was in Texas, Arizona, Colorado, Florida, and California.

Property in Massachusetts did not come on the scene until the demise of a New Jersey savings and loan in 1990. Not surprisingly many of the investments were outside of the Mid-Atlantic and New England area where the where thrifts were speculating in unfamiliar territory. Of the property in the New England region, 77 percent was in Massachusetts.[37]

An "Absolute Affordable Housing Auction" to sell 250 properties in Massachusetts, Connecticut, New Hampshire and Maine was held June 21-24 to give low- and moderate-income homebuyers an opportunity to bid on housing that was priced at $67,500 or less. "Absolute" meant that there was no minimum bid on the "affordable properties". Bidders had to pre-qualify with designated agents and were given a bidding range that they could afford. Both RTC and MHFA provided lower-interest financing through Shawmut Bank to qualified bidders. Property lists were made available prior to the sale and there were supposedly opportunities to view some of the property but the process was rushed and flawed according to the housing agencies involved.[38]

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37 "Trouble at the Finish Line"; *Boston Globe* Boston, Mass.; June 30, 1991;

38 Committee on Surplus & Foreclosed Housing; American Jewish Congress and CHAPA; Boston, Mass.; July 18, 1991.

A task force called "Committee on Surplus & Foreclosed Housing" organized by the American Jewish Congress and Citizens Housing and Planning Association (CHAPA), was concerned about a number of issues related to the auction process and questioned whether it was the right vehicle for selling affordable housing. First-time buyers were not given enough time to be counseled about homeownership nor had the chance to view the property prior to bidding. Disappointed buyers backed out of a few deals once they had a look at the house and got estimates on the amount of money and work that would be needed to fix-up their "bargain". The fast pace of the auction process and the mixture of general and affordable units meant that properties not sold in the general category were transferred to affordable with no time for the buyer to view the property or the documents prior to bidding.

Some of the CDCs would have liked time to negotiate with RTC prior to the auction to find opportunities to turn some of the properties into low-income rentals. There were a number of condos in one building that could have been aggregated as one purchase by a CDC rather than be put up for sale as individual units. For instance, one project had 13 units for sale, two projects had seven units each and four projects had four units each. Cheryl Walker, the Affordable Housing Specialist for the Northeast RTC, said that there were still some problems that needed to be worked out with the nonprofit agencies to fine-tune the process. They wanted to dispose of the property and meet the needs of the low-income families.[39] According to Walker, there were very few rental properties in their portfolio but they would look into ways of

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39 Interview with Cheryl Walker, Affordable Housing Specialist, RTC; Affordable Housing Auction; Boston, Mass.; June 23, 1991.

working with the CDCs. She suggested that the best approach was to contact the RTC in Valley Forge, Pennsylvania directly to find out what was available, or work with the designated liaison agencies in the area like the Women's Institute of Housing and Economic Development, MHFA, Massachusetts Nonprofit Housing Association and others.

The RTC was not included further in this analysis because of the complexity and scope of obtaining information about dealing with the RTC and the fact that most of their property was single family and not suitable for multi-family rental housing. Groups like CHAPA were working with the RTC and congressional representatives to propose changes that would make the Affordable Housing Disposition Program more effective. After a slow start the RTC had begun to move property and the transactions did not seem to pose the same problems that were plaguing the OREO properties held by the banks.

FDIC

The assets held by the Federal Deposit Insurance Corporation (FDIC) were part of the asset portfolios of insolvent commercial banks taken over by the agency. Before taking over a failed institution, the FDIC would try to sell off the branch offices and deposits to another bank so that the customers of the failed bank could still do business. The new bank had the option of taking over outstanding loans or properties as it chose, depending on the asset's performance. Those that were not taken were turned over to the FDIC for disposition.

The FDIC was the relative new kid on the block with property and was just beginning to initiate transactions in New England with many more anticipated in the future. The Franklin, Massachusetts Center had $2.2 billion worth of properties in the Spring of 1991 according to Lynn Leffert, most of which were condominiums, with some apartments and single family homes.[40] They had set up a real estate sales center with the intent of "moving property quickly". In July of 1991 there were 367 condominiums in foreclosure through the FDIC concentrated in Massachusetts and New Hampshire[41]. Liquidators in the Franklin office were considering using an auction to sell the property. The general consensus of the people familiar with the portfolio was that the properties were of a higher quality than the ones held by the RTC.

Some of the initial sale terms were difficult for the developers to meet: nonrefundable deposits and 30 day closing period, but the FDIC said it was willing to negotiate to cut a deal. Leffert stressed the need for groups to work closely with the account officer to specify the kind of property that was wanted and to build a relationship so agents could alert the developers to new properties when they came in.

MHP was working closely with the FDIC and was more willing to use their financing for the FDIC property, rather than bank-owned property, for a number of reasons.[42] One major reason was the lack of financing associated with FDIC as compared to OREO and RTC. The FDIC was more constrained

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40 Leffert, Lynn, Federal Deposit Insurance Corporation; presentation at Conference Beyond the Boom; MHP; Boston, Mass.; May 31, 1991

41 "Hundreds of Homes go on the Block"; *Boston Globe;* Boston, Mass.; July 13, 1991; p 61.

42 White, June 27, 1991

in its ability to set-up financing in that it required an act of Congress. In fact pending legislation in Congress was being considered that would add financing to FDIC property. Banks, on the other hand, were in the business of lending and therefore, MHP believed that, public programs should not be used to bail-out problem loans when banks had their own resources.[43] MHP was planning to use some of their financing to faciliate a better price from the FDIC by working with developers on specific projects.

Conclusion

The pieces needed to make an affordable housing project work seemed to be in place. There was a new source of funding and a climate of cooperation among the banks and there was a supply of existing housing with eager sellers anxious to get rid of it for discounted prices. For the nonprofit and for-profit developers trying to develop affordable housing it seemed like an opportune time to be in business, yet deals for affordable rental housing were not getting done. What were the obstacles facing developers who were trying to combining these resources to make affordable housing happen in Massachusetts?

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43 Ibid.

CHAPTER 4
OBSTACLES TO IMPLEMENTATION

REGULATORY LIMITATIONS ON BANKS

Banking Regulations

In order to understand some of the problems that a buyer might have in trying to purchase bank-owned property, it may be helpful to review some of the regulatory requirements that a lender is obligated to follow when dealing with problem assets. Commercial banks are regulated by several organizations. Nationally-chartered banks are regulated by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board. State-chartered banks are regulated by the Federal Deposit Insurance Corporation (FDIC). Savings and loans are regulated by the Office of Thrift Supervision (OTS), formerly the Federal Home Loan Bank Board (FHLBB).

When dealing with problem assets both commercial banks and thrifts follow a similar procedure that is stipulated in the Statement of Financial Accounting Standards (SFAS) regulated by the OCC.[1] The lender's orientation is to keep the regulatory capital of the lending institution from falling below the prescribed regulatory threshold. In an effort to avoid losses from problem loans, and therefore preserve the required capital level, lenders will go to great lengths to "work out" the loan to avoid loss recognition from a regulatory standpoint. Because losses reduce regulatory capital on a dollar-

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1 Myers, Thomas. A. & Co. *Real Estate Problem Loans: Workout Strategies and Procedures.* Homewood, Illinois: Dow Jones - Irwin; 1990, p 189.

for-dollar basis, struggling lenders strive to avoid recognizing such losses whenever possible.[2] When faced with a problem loan, lenders have two fundamental choices: either modify the loan agreement in an attempt to work out the situation with the existing borrower or repossess the property through foreclosure or deed-in-lieu of foreclosure.[3] Under the SFAS, upon repossession, the asset must be written down to its fair value, which is the amount that an owner can expect to receive for the sale of the asset and is measured by market value.[4] This write-down at repossession can result in a significant loss in the asset value which in turn effects the net worth requirements of the lending institution. Once repossessed, the assets are designated as real estate owned (REO) in the case of thrifts and other real estate owned (OREO) in the case of commercial banks and are distinguished from other real property held by the institution.

Once an institution is burdened with a large portfolio of problem assets it is highly motivated to get those assets off its books. The regulatory agreements under OCC do not allow a bank to own or be a developer of real estate for more than five years, without OCC approval, unless it is for bank use. A national bank may only own real-estate that is needed for bank purposes such as headquarters, branch offices, or a processing center.[5] When a property is foreclosed-on then the property becomes OREO and the charge is to liquidate the property in compliance with regulations.

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2 Ibid., p 189.
3 Ibid., p 191
4 Ibid., p 195
5 Armstrong, Kate, Vice President Shawmut Bank; presentation at conference "Beyond the Boom"; MHP; Boston, Mass; May 31, 1991

The SFAS has guidelines which set conditions that must be met for a transaction to be treated as a "true sale". A sale will not be recognized for accounting purposes if the selling institution retains certain ownership rights or has a "continued involvement" in the property without actually transferring the risk and rewards of the ownership to the purchaser.[6] Any gain on a sale must be postponed and accumulated in a special account if "continued involvement" involves any of the following conditions:

1. An obligation to repurchase the property.
2. An equity interest in the sold asset.
3. A guaranteed return on the asset to the purchaser.
4. Agreement to subsidize operations from the property.
5. Operating the property.[7]

A true sale is one in which the institution neither provides financing to facilitate the sale nor retains any continuing obligation with respect to the property. Gains for a true sale may be recognized at the time the sale is completed.

In an effort to sell problem assets, an institution often makes a loan to the purchaser to facilitate the sale. Full gain can be recognized under these circumstances if the following conditions are met:

1. The sale is finalized.
2. The buyer has sufficient resources and can demonstrate ability to pay for the property.
3. The lender's loan is not subject to subordination.
4. The lender has transferred all risks and rewards to the buyer and does not have continuing involvement. [8]

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6 Myers & Company, p 197
7 Ibid., p 197
8 Ibid., p 198

One Bank's Limitations on OREO

Kate Armstrong, Vice President of Shawmut Bank in Boston under national charter, explained some of the basic limitations and obligations that they were under in dealing with the disposition of their OREO portfolio.[9]

Foreclosure - A fundamental point to understanding what a bank could and could not do with a real estate asset was that the bank must first obtain ownership of the property before it had the right to negotiate with a buyer. A bank took possession through the process of foreclosure which could take 8-10 months in Massachusetts. Prior to starting the foreclosure process an owner had to be delinquent on payments for at least 45 days but most banks will not go to foreclosure until the loan was delinquent for 120-150 days. Banks used the term "non-performing asset" differently but it essentially meant that the loan was past due by more than 90 days. In essence, an owner could go for 12-18 months without making a single payment on a property prior to the bank taking it over and evicting the occupants.

A bank further has the option of not foreclosing or taking the property into possession thus leaving it in "limbo" where it might not be occupied but the bank does not have legal possession to sell it. This limbo state occurred more frequently because of environmental liabilities, like lead paint and toxics, that banks were reluctant to assume. An owner may have disappeared, so the bank could only board-up the building to protect the collateral but was not able to initiate a workout. Armstrong explained,

> People are very angry at the loss of their property. Sometime it's a tenant who has been making payments but the landlord hasn't made the mortgage payment. Vandalism on property that has been taken over by the bank is a real problem and can be extreme. In one house, the entire kitchen was removed - appliances, cabinets, even the kitchen sink.[10]

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9 Interview with Kate Armstrong, Vice President Shawmut Bank; Boston, Mass.; July 1, 1991

10 Ibid.

Maintenance - There were limitations on what the bank could do to the property beyond basic maintenance and repair. The bank could not add-on to the structure, make improvements, or develop the property without OCC approval. The asset managers at Shawmut were authorized to cure code violations. Under the definition of maintenance, Shawmut had fumigated the residence, obtained heating oil, and painted to make the house habitable for people who were still living there.

Since the bank was so limited in what it could do to improve a property it was likely that a buyer could get a better price if they were willing to take the property "as is". This was particularly important when it came to cleaning-up lead paint or toxic problems. Buyers are in a position to negotiate a better price if they assumed that liability and repair.

Appraisals - There had to be a current appraisal of the property to determine market value and fair value. A market value appraisal assumed a willing buyer and seller with no margins and a sale within 12 months. Fair value meant the value was adjusted if it was not sold within the year. Shawmut adjusted prices frequently to "mark to market".

Holding Period - Shawmut could not hold OREO for more than five years, under its national charter, without OCC permission. In other words, a bank could not hold on to a property with hope of recovery and increase in value even if it was a great property. It had to be sold within five years.

Bidding Strategy - Prior to a sale a bidding strategy (or Asset Disposition Plan) had to be prepared describing how the property would be sold and the process to be used. In this way the bank could not be accused of favoritism or negotiating with a buyer prior to the bank's ownership. If there was any irregularity, the regulators or the former owner could come back and claim that the bank by its actions "chilled the sale". The asset managers at Shawmut were responsible for preparing a Bidding Strategy.

Marketing - The bank had to market the property aggressively including on-going management and the provision of sale information to prospective buyers. The OCC required proof of marketing attempts and buyers reactions prior to allowing the bank to reduce the price.

A Sale - The goal was to remove a non-performing asset (OREO) from the books. If Shawmut sold an asset and got less than a 10 percent down payment, or provided 100 percent financing, or below-market financing it was considered a "covered transaction" and the non-performing asset was not taken off the books. The transaction was not considered a true sale, which of course was the bank's goal. Buyers were in a better position if they were willing and able to pay cash rather than incur any extraordinary financing from the bank. The price would likely be lower with cash. It might be difficult for many banks to give a special financing deal depending on its state of health. [11]

The regulatory limitations imposed on banks were a major obstacle in a bank's ability to negotiate to give the developer a "better deal" on the property. The general health of the bank and the size of its OREO portfolio were factors that influenced how far a bank could go in disposing of an asset.

CRA

Another piece to the affordable housing puzzle was the federal incentive for lenders to lend in low-income communities where much of the affordable housing was located. The Federal Government enacted the Community Reinvestment Act (CRA) in 1977 in response to redlining. It state that "Financial institutions have an obligation to seek out and meet the credit needs of their entire community, including the low- and moderate-income neighborhoods that they serve, without jeopardizing the safety and

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11 Ibid.

soundness of the bank."[12] The law contained three requirements: an annual CRA statement; a CRA notice to be posted in each branch; and a file for public comments. Banks were subject to a performance rating system that indicated their conformance to community lending practices. Enforcement was not an issue unless the bank applied for a merger, acquisition, or new branches.[13] A change in the rating categories and public access to the performance review of the bank were included in changes to the CRA regulations in 1990 as part of the FIRREA. This increased the enforcement capabilities of community groups who, under the provisions of the legislation, were able to protest bank expansions or mergers on the basis of their community lending records.[14] One of the problems with CRA was the vagueness in specifying how banks were to "satisfy the lending needs". It was up to the examiners as to whether some action or program counted in the performance rating.

The Massachusetts community groups were very effective in using the CRA provisions to increase lending in minority communities like Dorchester and Roxbury. The purchase of Bank of New England by Fleet/Norstar brought a great deal of public pressure from groups like the Union Neighborhood Assistance Corp., lead by Bruce Marks, who demanded that the bank increase community lending to rectify second mortgage abuses in the minority neighborhoods . In an effort to satisfy community demands for improved

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12 Waltch, Alison and Lauri Webster. *Commercial Bank Lending Practices in the Development of Urban Projects;* Cambridge, Mass: MIT Center for Real Estate Development; September 1990., p 25.

13 Warf, Patricia. "Expanding the CRA Statement"; *ABA Bank Compliance;* Autumn 1990; p 26.

14 Duenes, Laura. *Community Development Lending;* Cambridge, Mass.: MIT Department of Urban Planning; May 1989; p 6

lending in minority communities, Fleet pledged to provide $111 million in an overall community reinvestment plan.[15]

The state of Massachusetts also has a statute for Community Reinvestment which follows the Federal Act very closely. The issue of particular concern in this thesis regarding OREO property, is whether a member bank can receive CRA credit for selling property at a price below the outstanding mortgage balance if the property is to be used for affordable housing? A subcommittee of "Committee on Surplus & Foreclosed Housing" was investigating this issue but was unable to obtain an official ruling by CRA regulators. Provisions in the regulations point to the possibility. Both the federal and Massachusetts versions of CRA specify factors for assessing a bank's CRA performance,.including "the bank's participation, including investments in local community development and redevelopment projects or programs" (12C.F.R. sec. 25.7(h) and G.L. c.167, sec. 14(h)). Evaluation factors in Massachusetts include "the bank's use of more flexible lending criteria" (c. 167, sec. 14(i)) and "the bank's origination of loans and other efforts to assist existing low- and moderate- income residents to be able to remain in affordable housing in their neighborhoods" (c. 167, sec 14(l)).

Implementation of CRA lending was usually handled through special community lending departments within the bank. Bank officials were expected to develop expertise and a relationship with local community groups to identify credit and banking needs for the low-income neighborhoods. Community development projects required complex deal

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15 ""Can One Bank Make a Difference?"; *Boston Globe;* Boston, Mass; July 16, 1991 p 40.

structures involving layered financing and modified lending criteria. Loan officers became specialists in understanding the complex funding regulations that usually accompanied a project from a local CDC. That kind of expertise was not necessarily shared by other loan officers who dealt with conventional mortgages and commercial loans. This is of particular concern in the use of OREO property for affordable housing. The expertise of the CRA officer was needed in the transaction but was not necessarily part of the loop for disposing of the property.

ACCESS TO OREO PROPERTY INFORMATION

Chapter 3 highlighted some of the sources of property as an opportunity but the ability to gain access to information had turned into an obstacle as well. The individual banks dealing with OREO properties had no system for centralization between banks and sometimes even within the bank and were somewhat reluctant even to talk about OREO property in a group forum.[16] In the past, OREO was a very small part of a bank's operation: maybe only a few foreclosures a year. But now some banks faced as many as 50-300 residential foreclosures in process at any one time depending on the size of the bank.[17]. Other banks, like State Street Bank and Bank of Boston, may have had many commercial OREOs but very few were apartments or properties suitable for rentals, according to their OREO staffs. The growing size of some of the bank's OREO portfolios and the magnitude of the problem caused many banks to adopt new strategies to deal with it.

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16 Telephone interview with Martha Ikerd, Director of Research, Massachusetts Bankers Association; Boston, Mass.; July 3, 1991.

17 Armstrong, July 1, 1991.

Where to Start

Various banks had organized the people responsible for OREO differently. Some had set-up an OREO division within the bank, comprised of bank people; others had created a separate subsidiary; and still others had used an outside consultant to create a special asset group that worked within the bank. The variations depended on the size of the bank's portfolio and degree of management sophistication in dealing with OREO.

Shawmut created an in-house OREO department which handled the foreclosure, management, and liquidation of property. Armstrong manages Residential Asset Group (1-4 family and condos) within the Real Estate Investment Banking/Other Real Estate Owned. This group handled 1-4 family and individual condominiums irregardless of location. There were four separate groups divided by geographic location for commercial property that included apartments, condominium projects, and raw land. Asset managers coordinated the management and disposition strategies for a number of properties including handling of marketing, management, and sales for individual properties, by working with real estate brokers .

Outside brokers were used by most of the banks surveyed, to list and sell the OREO property. Lists from the bank would include the broker's name to contact to view the property and handle any inquiries about taxes, conditions, expenses and other property information.

Bank of New England/Fleet created a wholly owned subsidiary called Recoll Management Corp. to manage and dispose of $600 million in assets held by the FDIC after Bank of New England went into receivership.[18] Prior to Recoll, the subsidiary was called Pertnax and was set up to improve organization and limit liability to the parent company. Recoll had a five year contract with FDIC to manage not only the BNE property but other troubled loans from smaller failed banks. According to Thomas W. Lucey, Recoll's president,

> "We are a service company. Our mission, simply put is to manage, liquidate and collect a pool of assets owned by the FDIC....While markdowns may be necessary to sell some properties, others may be held for a while so they can appreciate in value or generate income to offset future losses."[19]

Recoll produced a monthly list of commercial and residential property organized by geographic area. People wanting to obtain information about specific kinds of property were asked to make the request in writing.

Another method of organizing the disposition of OREO was developed by consulting firms marketing a package of services to a bank to help manage the OREO problem. Mark Hall at Hunneman Investment Management Company created such a package of services, including forms and processes,to act as an outside asset management group.[20] A "Special Asset Group" would be formed within the bank, staffed by people under contract with Hunneman. The portfolio Asset Management Team would perform all necessary due diligence to prepare an Asset Management Disposition Plan to comply with OCC requirements. Using a systemized approach they would also be responsible for all marketing, tenant, reporting, management and sales related to the assets. Hunneman had been working with banks since 1988 to

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18 "Bank of New England a Special Situation"; *Boston Globe;* Boston, Mass.; July 21, 1991; p A52.

19 Ibid.

20 Interview with Mark Hall, Senior Vice President, Hunneman Investment Management Co.; Boston, Mass.; July 9, 1991.

perform these services. Most of their work was with the larger commercial properties rather than the 1-4 units.

Rivalry Among Banks

Another problem in dealing with banks about their OREO property, was the lack of open communication about it. Most banks had gotten past the denial stage but they were still reluctant to reveal basic information about the amount of OREO that they owned because it was still a stigma and source of embarrassment within the banking community. Part of this may have been due to pressure from regulators and the overall health of the bank. Hall pointed out that, "Many banks were under strict enforcement orders to cleanup their nonperforming loans and bad assets or be closed down."[21] It was perceived as an in-house problem that they had to deal with privately. The Massachusetts Bankers Association organized a seminar on OREO in May 1991. It was a sensitive issue, even down to deciding what to call it in order to attract attendees. Maximizing the Value of Real Estate Owned had three speakers, including Mark Hall from Hunneman, Norm Lyttle from Recoll, and Stan Regalevsky, an attorney who covered the regulatory and liability issues, as well as different ways to organize the OREO functions.

A part of the secrecy had to do with competition among the banks in their efforts to sell their unwanted property. In a declining real estate market, like New England was experiencing, there were not a lot of buyers so each bank was working separately to price and market assets, even if more than one bank-owned condominiums in the same building. Hall had worked in a

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21 Ibid.

number of situations where more than one bank had an interest in a project and had had mixed experiences.[22] In a few cases the "smarter" banks agreed that one bank should take the lead and handle the pricing, terms, and disposition strategy. Other cases were riddled with problems. Banks wound up suing each other or reaching a stalemate because they could not agree on basic pricing or terms to even begin marketing the property as one project. Some of it was due to personality problems between loan officers or bank presidents, others had to do with different regulatory pressures and direction from upper level management. The situation was frustrating for everyone concerned and usually cost the banks more money because of delays.[23]

No Priority for Affordable Housing

Given the regulatory pressure to obtain the highest price and the unwillingness of banks to talk about the problems together, it was not surprising to learn that community investment and affordable housing were not easily recognized in the disposition strategies for the OREO property. Each bank had its own policy and method of dealing with the issue. Some banks like Boston Bank of Commerce worked closely with their CRA officers and actively looked for properties that would be suitable for the local CDCs.[24] Other banks did not think they had enough property that fit the affordable housing category and so did not pursue it.

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22 Ibid.

23 Ibid.

24 Interview with Warren Smith, President and COO, Boston Bank of Commerce; Boston, Mass.; July 9, 1991. The Bank is the only African American owned bank in New England and specializes in serving to revitalize the minority communities of Boston.

The bulk of the residential OREO property was in the 1-4 family category while very few banks had apartment projects over 5 units that were categorized as commercial. Warren Smith, President of the Boston Bank of Commerce, described some of the difficulties in marketing the 1-4 family units to the CDCs.

> Many of the old brick buildings in Dorchester and Roxbury were bought by investors who converted them to condominiums during the mid 80s. Almost all of them had some form of rehabilitation ranging from cosmetic improvements to up to $50,000 worth of work per unit. By claiming to spend more than $30,000 per unit, the building could be exempted from the city's rent control limits. Buildings bought for $120,000 total were then marketed for $150,000 per unit after rehab but then the market disappeared. In July 1991 those buildings were selling for $110,000-150,000 per building (3-4 units per building). The rents could not support the mortgages on the properties and people were defaulting. Some of the monthly costs were due to the condo conversion. A converted building was taxed as separate units versus a rental which was taxed as one. It meant as much as $500 more per month per unit. Another problem peculiar to Boston was the cost of water. Water rates could run as high as $1,000 per fiscal quarter for a triplex.
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> Once the buildings were in foreclosure the bank discovered that some of the rehab work did not matched the money that had been spent. The biggest problem was with lead paint. It was a major liability for banks that they did not want to assume. Costs ranged from $4,000-7,000 per unit to have it removed by a licensed person. Units could not be rented under the HUD Section 8 Certificate program unless the lead paint had been removed. The bank was willing to sell units for a deeper discount if a buyer was willing to bring it up to code and comply with the lead paint removal but that meant more money needed from the buyer for rehab.
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> The CDCs had been approached about the units in the Boston Bank of Commerce portfolio but the local groups were tied up in larger projects

and did not have ready funding available to take on small projects that were not necessarily cost effective. There was some potential interest from the CDCs for the future, but the bank was concentrating on finding owner-occupant buyers for the units now. The numbers just did not work for an investor unless the units were priced a lot lower. [25]

FINANCING THE PROJECT

Perhaps the biggest obstacle in trying to produce any affordable housing was the ability to finance a project. There were a number of major constraints in obtaining bank-owned property that were brought up again and again by the people interviewed :

1) *OREO Pricing*: OREO property was not priced realistically and low enough to make projects affordable to low-income families;

2) *Bank Financing:* banks needed to provide their own financing for their OREO property;

3) *Access to Loan Pools:* the new loan pools (MHP, MHIC, AHP) should not be used to help bail out member banks from their problem assets;

4) *Finance Structure:* a workable finance structure or Model was needed to speed-up the finance process and to use as a benchmark to evaluate deals.

OREO Pricing

Housing advocates and nonprofit developers believed that the banks had not recognized the true value of the OREO properties and were still pricing them too high given the deteriorated condition and the unmarketability of many of the rental units. Banks had not taken "the full bite of reality", explained Larry Curtis from Winn Development Company, they were still 20-30 percent off a

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[25] Ibid.

realistic price.[26] Winn was a large private developer of affordable housing in Boston, actively looking for OREO properties yet they had only received three unsolicited calls from brokers or banks with OREO to sell.

According to Carl White at MHP, "Some banks are unwilling to foreclose on property because of the liability issues involving lead paint so the property is left to deteriorate while they look for a buyer." [27] Shawmut and Bay Bank were among the few banks that had taken over many of these 1-4 family buildings and were trying to sell them to local CDCs. Only Bay Bank had carried out a successful program in Springfield.

There were costs in holding a property and doing nothing. It not only affected the bank's bottom line but it affected the community and the neighborhood as properties deteriorated or were vandalized. The worse the condition the more that would be needed for rehabilitation which would mean less money available for acquisition.

Banks were constrained by their own regualtory requirements to get as much as they could for the property. Small banks under the tight scrutiny of the regulators were afraid of getting seized if they took less than appraised value. A bank could take less than the appraised value for an OREO property, without OCC approval, providing it made a sound business decision that was well documented (i.e. the property had gone unsold for an extended period of

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26 Interview with Larry Curtis, Project Director, Winn Development Company; Boston, Mass.; July 22, 1991.

27 Interview with Carl White, Director of Program and Policy Development, Massachusetts Housing Partnership; Boston, Mass.; June 27, 1991.

time)[28]. Developers were caught in the dilemma of how long to wait before making an offer on a property. It was usually better to let a property go through foreclosure and the auction process before making an offer or finalizing negotiations so the developer could be in the best position to get the lowest price. On the other hand the banks did not want to lose money so they were holding out. "It's a game of hard ball. Banks have to be ground down to make the prices realistic and low enough to be affordable for low-income housing."[29]

But not all developers believed that they were paying less than market value for affordable housing. There was a misperception among the banks that if a project sold for low-income housing they would be taking less than market value. The Winn Company was paying market for the new condominium projects that they were purchasing in places like Quincy and Revere. At $60,000 a unit for a newly constructed project, they were getting a high quality condominium intended for middle class America and turning it into an affordable rental with Section 8 subsidies and tax credits. to fill the gap.[30]

Another part of the equation was the basis used for the appraisals. Some people believed that rental property, particularly low-income, should rely on proforma information and not market information to determine value. The assumptions used for expenses and rents made a big difference in the net operating income which was then capitalized to determine value. Rents for low-income units had to be below certain levels to meet the requirements of

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28 Armstrong, July 26, 1991.

29 Ibid.

30 Curtis; July 22, 1991

various funding programs. Expenses were also higher in comparison to market-rate rental units. Banks holding on to hard-to-sell property needed to reevaluate pricing to more realistically reflect the proforma for low-income housing.

Bank Financing

One of the biggest obstacles for both nonprofit and for-profit developers was the ability to obtain permanent financing for rental housing. An obvious source of permanent financing for a project was the bank itself. While bankers were under pressure to comply with regulatory requirements for getting a bad loan "off the books" they were still able to carry financing on an OREO sale provided that the borrower and the loan met the standard lending criteria. A bank that was asked to take back some of the financing was often reluctant to negotiate a better price. If it had a choice it would prefer the cash so it could walk away from the whole thing. A for-profit developer could often obtain a lower price for a project by offering a quick closing, no mortgage contingency, and cash. A CDC with few of its own resources wanted the good price and the financing and often took longer to close a deal while waiting for other parts of the financing package to come together.

Armstrong pointed out that banks were under stricter regulatory requirements for commercial loans than they had been previously since the introduction of the Basle agreement three years ago. Multi-family (over four units) is considered a commercial loan and must have 100 percent of the capital required in reserve.

Carl White at MHP felt that banks were almost obligated to provide financing for their OREO property in order to attract other financing.[31] Another developer had a different view, "Pricing the OREO low enough made a bad deal into a great deal so why shouldn't another bank be willing to loan?"[32]

One of the obstacles interfering with bank financing had to do with stricter regulatory requirements imposed by the "credit crunch" that was plaguing the banking industry in general. Over the past two years banks were focused on internal matters to control the damage caused by bad loans and tighter regulatory scrutiny by the bank examiners. "Lenders had a psychological fear of lending money after having their loan decisions ripped into by regulators for more than a year."[33] The arrival of Fleet/Norstar with $600 million in cash to "kickstart the credit-starved Massachusetts economy" was a ray of hope on the banking horizon.[34]

Access to Loan Pools

One of the underlying premises to this thesis was that new funding pools (MHP, MHIC, AHP), sponsored by banks, would be a natural vehicle to combine with discounted OREO property to create affordable housing. What became apparent during the interviews was that there were inherent conflicts in this combination that could be termed as "double dealing". The loan pools were sponsored by member banks to specifically work with developers to create financing for affordable housing yet they were reluctant to use those funds for an OREO property. Carl White said that, "There is a perception of

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31 Ibid.
32 Interview with Caleb Clapp, Renwood-CCC; Boston, Mass.; July 1, 1991
33 *Boston Globe;* July 16, 1991; p 40
34 Ibid. p 35.

bailing out the banks if MHP funds were to be used for OREO property." With the MHIC fund, Joe Flatley believed that "Member banks wanted their money invested in the community and not used to help out an individual bank with problem assets. The bank selling the property should do its own financing."[35] As White put it, "If the bank that owns the OREO is unwilling to finance then why should others? Maybe the price is too high or something is wrong with the project. Why should another bank take on a questionable deal?" Clearly none of the banks or loan programs should be used to fund a bad loan

John Eller at the FHLB said that the regulations for the Affordable Housing Program did not have a prohibition against using bank-owned property yet the national Federal Home Finance Board in Washington, which approved all projects, was concerned with some deals which involved OREO and FDIC-held property although there was no problem with RTC or HUD property. He felt that member banks should disclose if a property was OREO and submit appraisals to be fair to the other projects.[36]

A few OREO transactions had taken place which were financed by the new loan pools. MHIC had 32 projects totalling $558.6 million in the pipeline for funding or approvals as of May 31, 1991, and only one of those involved an OREO. AHP completed its third round of funding for projects June 19, 1991 totalling 431 units and $6.9 million in grants and only one project, with Lynn

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35 Interview with Joe Flatley, President of Massachusetts Housing Investment Corporation, Boston, Mass.; June 27, 1991

36 Interview with John Eller, Assistant Vice President/Assistant Director of Housing and Community Investment, Federal Home Loan Bank of Boston; Boston, Mass.; June 18, 1991

Economic Opportunity Inc, for 120 units of Single Room Occupancy housing was an OREO property.

The two developers in the case study indicated difficulties in trying to obtain permanent financing loans through the AHP program. The problem of obtaining permanent financing for any of these projects revolved around selling the loans on the secondary market. The national FHLBanks, as well as a state task force, were working on ways to standardize the loans so that they could be sold to pension funds and other long term investors.[37] "The risk of default on these loans is not as high as conventional projects but you've got to be able to standardize the terms so that a Vermont deal can be sold to an investor in Virginia," explained Eller.

ROAD BLOCKS FOR THE NONPROFIT DEVELOPERS

Credibility of the CDCs

The local community development corporations (CDCs) in Massachusetts were a mix of large and small nonprofit developers that had a well organized network of agencies to support them. Groups like Massachusetts Housing Partnership (MHP), Massachusetts Housing Finance Agency (MHFA), Community Development Economic Assistance (CEDAC), and Massachusetts Community Development Corporation (MCDC) all provided technical assistance, political support, and sometimes financing to the 50-60 CDCs in Massachusetts. Most operated in a very limited geographic area concentrating in the neighborhood that prompted their original organization. The level of

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37 Ibid.

sophistication related directly to the number of projects that they had completed and the experience and ability of staff.

Some of the banks felt like they needed protection from nonprofit developers who were fairly aggressive in their negotiations for property and did not seem to be aware of the regulatory restrictions. Were they taking advantage of the banks or were they simply doing whatever it took to make a project affordable?

Many of the housing agency support groups had come a long way improving the capabilities of the CDCs and raising their status in the banking community. Some banks, however, were not convinced that CDCs were the right vehicle for creating affordable housing and may have been the cause of problems that made it harder for private developers to get things done.

In general, bankers would agree that the CDCs were an important linkage to the low-income communities that they represented. Those banks experienced in working with a CDC, knew it was familiar with its neighborhoods and was able to handle rent-up and management of projects well since it was close to the needs of the residents. Some bankers did not have that record of experience and believed that a pre-screening process would be helpful so they could check-out the financial and management capabilities of the corporation, much as they would any other new borrower.[38] This was a sensitive issue, especially for the small CDCs with limited project experience. The problem was compounded in the case of OREO property

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[38] Davies, Susan. Meetings with Massachusetts Bankers Association as part of Committee on Surplus and Foreclosed Housing; CHAPA; Boston, Mass.; May 28, 1991.

because the brokers and outside consultants, dealing with the disposition, were not part of the bank and did not need to "build a relationship" with the new buyer.

More Time and Too Little Money

Lenders were reluctant to work with a CDC, especially for OREO, because it took too much time and the nonprofits had too little money to bring to a deal. As mentioned earlier, the banks wanted to sell the OREO property as quickly as possible, which in their terms translated into cash transactions with no financing contingencies. CDCs were notorious for their lack of working capital to put into a deal and the amount of time that they required to close a deal as they put other financing pieces together. "Banks were expected to take a hit if they sold to a CDC," said one banker, and they were not always willing, at least not at first. "Taking a hit" meant lowering the price substantially in order to make the project affordable to low-income tenants. The loss of subsidies from the state and federal government meant that those prices had to go even lower and some banks were not willing to take that much of a loss except as a last resort.

Armstrong summed it up by saying,"The problem is that CDCs want it all- a deep discount on price and special financing, but the bank can't do it all. Both sides have got to be more realistic." [39]

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39 Eller; June 18, 1991.

High Development Costs

Another issue was whether the CDC and small start-up developers had the financial net worth to support a project. Some of the OREO properties had real problems either because of rehabilitation work that was needed or higher operating expenses because of neighborhood problems. The CDCs did not have deep pockets or the back-up resources to support the mortgage if costs went up. It was not only the financial capabilities but the management capabilities of the staff. Some had strong management experience while others were just starting out and had to rely on outside managers which added to project costs.

The overall costs of working with a CDC was another issue. The costs for a CDC project were generally higher than for those of a private developer doing low-income housing. The CDC often had to rely on outside consultants to prepare feasibility studies, financial analysis, proformas, seek outside investors, and negotiate with the banks, whereas a private developer was more sophisticated and able to perform these functions in-house. Another difference in cost had to do with the funding source. Some of the federal and local programs got carried away with bathroom requirements and unit sizes to the point that the units were getting too large to be built at an affordable price.

Competition for Section 8 Tenants

Most developers were relying on Section 8 or Chapter 707 certificate holders to support the higher rents needed to meet operating expenses and debt coverage. With more rental housing on the market and developers competing to get Section 8 tenants, it was a buyers market. Suburban apartments (formerly condos) with swimming pools, plush landscaping, and new appliances were no match for inner city mid-rise buildings. Winn Company offered the discerning certificate holder a strong management company with a commitment to long term affordability. The tenant would not have to bounce around from project to project. CDCs like Salem Harbor were depending on Section 8 for their project (see case study) but were worried that they might not be able to compete with newer buildings renting for the same price.[40] The shortage of certificates, along with the cut backs in the Chapter 707 program, made the CDC projects more vulnerable as rents deteriorated because of the real estate economy in Massachusetts.

Parity for CDCs and Small Developers

In order to be in a better negotiating position, CDCs and some small developers needed more flexibility in financing. They did not have cash reserves for property acquisition and relied on piecing together numerous funding sources to make a deal work, a process which took time. A developer often needed site control to obtain loans from foundations.[41] If the bank was unwilling to carry financing or extend a commitment then the CDC was no longer competitive with other bidders. According to Joe Flatley of MHIC, "Banks are more willing to cut a deal if it's a cash transaction. A bridge loan for the CDC would give it the power to close a loan with the bank." MHP and MHIC were working to make funds available to bridge that gap for the CDCs.

"CDCs need to push harder to get more of a discount from the banks," suggested White. There is so little public money available to subsidize a deal

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40 Interview with Viki Bok; Salem Harbor Community Development Corporation; Salem, Mass.; July 17, 1991.

41 Telephone interview with Susan Davies, Citizens Housing and Planning Association; Boston,Mass.; June 19, 1991.

so that banks and CDCs have to work harder to make a project work without state or federal support. On the other hand, "The loss of state subsidies may be a breath of fresh air. It will mean that banks and developers will have to get more realistic about property values," said White.

The CHAPA "Committee on Surplus and Foreclosed Housing" was working on ways to obtain affordable housing from the RTC and FDIC as well bank-owned property. One particular issue involved getting banks to recognize the problem the nonprofits were having and to deal with it as a group. The Massachusetts Bankers Association did not see this as a systemic issue but rather it was more appropriate for each bank to deal with its own OREO portfolio. There was a lot of frustration among the CHAPA members in trying to get the bankers themselves to come to the table to discuss the issues, one of which was their relationship with the CDCs.[42]

Fear of Foreclosure

Fear of foreclosure was another reason for banks to shy away from CDCs. It was hard enough to foreclose on a home or apartment because of a bad loan and nonperformance by a private developer but to foreclose on a low- or very low-income housing project owned by a nonprofit developer would be impossible. The Massachusetts banking community was suffering enough from poor public relations related to CRA compliance, second mortgage scandals, and the general lack of credibility due to threatening bank insolvencies. Foreclosing on low-income housing would be unconscionable.

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42 Meeting of the Committee on Surplus & Foreclosed Housing; CHAPA and American Jewish Congress; Boston, Mass; June 20, 1991.

A FINANCIAL MODEL

The financing of multiple-family housing is a challenge in the best of situations but to create affordable rental housing in a poor market requires extraordinary means usually through the intervention of the federal, state, and/or local government. Public intervention usually took the form of legislation to: 1) mandate requirements for affordable housing, 2) create tax incentives to encourage affordable housing, and 3) provide funding to subsidize affordable housing. As discussed earlier in this paper, the government was still in the business of the first two but had virtually withdrawn from the subsidized funding programs of the past. The new lending pools in Massachusetts were stepping in to try to fill the gap. Their financing, coupled with discounted OREO property seemed like a good match, but was it enough?

To answer this question we will look at two models which provide a framework for analyzing the cases in Chapter 5. One is the Community Investment Model described by Charles Riensenberg and Carolyn Line in their *Principals and Practices of Community Development Lending* . The framework of the techniques that they describe are then applied to a model for *Permanent Financing for Affordable Housing* prepared by MHIC for their funding program.

Community Investment Model

Riesenberg and Line describe a variety of Community Assistance Programs that lenders should consider when dealing with high risk or low return projects which generally describes the affordable housing profile. The objective is to increase income or reduce expenses to make the project financially feasible. The assistance techniques are as follows:[43]

Guaranteed Income - The problem with low-income housing production is the inability of projects to generate sufficient rental income to meet development financing and operating costs. Fair market rents, which are based on a standard level of rent to support the feasibility of a project, are generally more than 30% of the monthly income of a low-income family. The Federal Section 8 Certificate Program and the Massachusetts 707 Rental Subsidy Program provided additional rental subsidy to the owner to cover the difference.

Tax Credits and Depreciation - The two tax enhancement techniques commonly used to reduce or postpone tax payments are depreciation and tax credits. By applying these techniques, annual income tax payments are reduced, thus increasing investor income. If investment yields increase, social projects can raise more equity. The income tax incentives benefit the equity side of a real estate transaction directly but do not induce debt investment. By encouraging more equity, there is a reduced need for debt financing.

Long-Term Financing - Establishing the maturity of the loan repayment is the cornerstone of debt financing. A longer maturity date lowers the annual debt service requirement. It is important, however, to match the useful life of the asset to the term of the loan. This is particularly significant when dealing with older apartments and three to four family homes.

Blended Interest Rate - There are four options for lowering borrower financing costs. Each is a subsidy manipulating the effective loan rate.

1) Tax-exempt Financing: lowers the market loan rate by about 20 percent because the interest deduction effectively increases the return. Long-term, fixed-rate, tax-exempt financing is typically arranged in the national secondary market and enhanced through guarantees or letters of credit. Example: MHFA

2) Below-Market Rate Second Mortgages: are usually grants converted to loans, subsidized to the extent each grantor is willing to forgo return. These are commonly blended with a market-rate first mortgage from a traditional financial institution. Example: MHP

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43 Riesenberg, Charles E. and Carolyn P. Line. *Principals & Practices of Community Development Lending,* Federal Reserve Bank of Minneapolis; 1989; p 8-2-11.

3) Interest Subsidy Grants: are periodic cash payments that write down market-rate financing to a lower effective rate. Funding amounts are a combination of the desired effective interest rate, length of financing term and interest rate of underlying market financing.

4) Partial Equity Grants: reduce the cost of the loan by reducing the principal. If the community investment source is not concerned with recapturing its investment, project debt service can be reduced. Usually a lien is placed on the property during the market financing loan term restricting the use to affordable housing.

The MHIC Model

A number of housing agencies in Massachusetts including MHIC, MHP, and MHFA developed a "layered financing structure, with pre-packaged components, and coordinated underwriting" with the objective of working out the financial structure needed to support an affordable rental housing project without the use of federal or state rental subsidy programs.[44] The MHIC model was intended to combine some of the new funding resources so that developers and investors would have a financing structure that was flexible, easy to access, and predictable. The model identifies four pieces of the financing structure which are reviewed in the context of the Riesenberg and Line framework.

Guaranteed Income - The MHIC model particularly steers away from the reliance on ongoing rental subsidies from the federal or state government. Public subsidies would only be sought to support greater affordability or higher costs.

Tax Credits - Equity would be generated through investment by limited partners in tax benefits created by the Low-Income Housing Tax Credits. Through the participation of corporate investors who are able to take advantage of passive losses, and through efforts to minimize transaction costs, the net amount of equity raised will be maximized. Such investors

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44 "Permanent Financing for Affordable Housing"; Massachusetts Housing Investment Corporation; Boston, Mass.; May 14, 1991.

could be members of MHIC, National Equity Fund or privately placed syndication.

Long Term Financing - A first mortgage with a loan-to-value ratio below 70%, and with debt service coverage of at least 130%, which can be marketed to pension funds, insurance companies, or other institutional investors. This loan would have an interest rate which is approximately 150-200 basis points above the 20-year Treasury rate. The loan would have a 20-year amortization. Such a lender could be MHFA, MHIC, or a conventional lender. The originating lender may also have to warehouse the first mortgage loans until there is a package of sufficient size (perhaps $25 million) to be purchased by an institutional investor.

Blended Interest Rate - Second Mortgages of as much as $20,000 per unit would be offered, structured so as to enhance marketability of the first mortgage, yet with clear expectation of repayment. The loan would have an interest rate approximately 150 basis points above the bank cost of funds, with a 30-year term, interest only during the first ten years, and amortized over the last 20 years. Such a loan could come from MHP, Massachusetts Government Land Bank, or MHFA.

Exhibit A shows a layered financing structure that combines the resources described in the model for a hypothetical 100 unit project. The format for the model is used in the analysis of the two case studies described in Chapter 5.

EXHIBIT A
PROJECT FEASIBILITY ANALYSIS
MHIC LAYERED FINANCING STRUCTURE

PROJECT ASSUMPTIONS

		Monthly Rent
Number of Units:	100	$678
0-1 Bedroom:		
2 Bedroom:		
3 Bedroom:		
Operating Costs:	$4,000	per unit/yr
Vacancy Rate:	5%	per year
Replacement Reserves:	$300	per unit/yr
Affordability: 100% Very-low and low-income: Sect 8		

OPERATING PROFORMA

	Stabilized Year
Gross Rental Income	813,600
Vacancy	40,680
Net Rental Income	**772,920**
Operating Costs	400,000
Replacement Reserves	30,000
Net Operating Income	**342,920**
Subsidies	0
Income Available for Debt	342,920
Debt Service, 1st Mort	156,265
Debt Service, 2nd Mort	170,000
Other loans	0
Cash Flow	**$16,655**
Debt Service Coverage	105%
Loan to Value Ratio	61%

SOURCES OF FUNDS

	Amount	*Interest*	*Percent of Sources*	*Term*	*Source*
Equity:	2,187,049		39.2%		Tax Credits
1st Mortgage:	1,397,020	9.5%	25.0%	20	MHFA, MHIC
2nd Mortgage:	2,000,000	8.5%	35.8%	30	MHP, MHFA
Other Loans:	0				
Gap Financing:	0				
Total Sources	**$5,584,069**		**100.0%**		

USES OF FUNDS

	Total Cost	*Per Unit Cost*	*Percent of TDC*
Acquisition Cost	2,000,000	20,000	35.8%
Rehabilitation Cost	2,584,100	25,841	46.3%
Soft Costs	776,637	7,766	13.9%
Development Fees/Cost	223,363	2,234	4.0%
Total Development Costs	**$5,584,100**	**$55,841**	**100.0%**

Source: Massachusetts Housing Investment Corporation MHIC

CHAPTER 5
CASE STUDIES

SALEM HARBOR COMMUNITY DEVELOPMENT CORPORATION

The Developer

Salem Harbor Community Development Corporation was started in 1979 by residents of the Point neighborhood in Salem to help preserve affordable housing in their community. The Point was one of Salem's neediest neighborhoods with the largest low-income neighborhood on the North Shore. It was home to many immigrant families working in local manufacturing and service sector jobs. Approximately 50 percent of the Point's residents were first-generation Hispanic families from Central America and the Caribbean who were barely able to speak English.

The CDC had limited experience in both housing and economic development. Their accomplishments included the development and management of 45 units of housing, the start-up of several local businesses, and the creation of two day-care centers and a community garden. Viki Bok the Executive Director, had been with the CDC for a year and a half working with one other staff member.

The Project

Salem Harbor CDC, along with a coalition of residents and local nonprofit groups, was trying to purchase and renovate 77 units of dilapidated, bank-owned, family housing to be known as **Salem Point Cooperative Apartments.** The 11 buildings started with over 70 families in the Summer of 1989 and had dwindled to 30 by Summer 1991, who were working with the CDC to purchase the buildings, undertake a complete renovation, and convert the units from rental housing to limited-equity cooperatives. The objectives of the project were:

> "To give the residents an ownership stake in their housing in order to interrupt the cycle of speculative real estate buying and selling, absentee ownership, and disinvestment which has plagued the Point for many years and to allow current residents to remain in their homes at affordable rents. In total the residents hoped to obtain increased control over the neighborhood's housing resources".[1]

The buildings were 3- and 4-story brick structures housing with seven or eight units in each. Of the 77 units, 48 had two bedrooms and 29 had three bedrooms. Rents were targeted to three categories: 20 percent were Section 8 or 707 Certificate holders; 45 percent were for low-income tenants earning less than 80 percent of median income; and 35 percent were for moderate income tenants earning more than 80 percent of median.

Salem Point Cooperative
Projected Rent Structure

	Section 8/ 707 Units	*Low Income Units*	*Mod/Markt Units*	*Total/ Average*
2-Bedroom				
Units	8	20	20	48
Aver. Rents	$678	$438	$563	$530
3-Bedroom				
Units	7	15	7	29
Aver. Rents	$800	$554	$729	$656
Percentage	15%	45%	35%	100%

Source: Salem Point Properties Operating Proforma, June 17, 1991

1 "Request for Funds"; Salem Harbor Community Development Corporation; Salem, Mass.; June 1991.

OREO History

The 11 buildings in this project had been part of 17 buildings in Salem owned by a Topsfield developer who had been speculating on the rapidly escalating real estate prices at the Point in 1986. His plans to convert the buildings into condominiums and high rent apartments were blocked by tenants and local groups who wanted to prevent the conversions and force him to bring the buildings up to code.

The softening real estate market ultimately resulted in the developer defaulting on his mortgages and the Bank of New England (BNE) began foreclosing on all the buildings in the summer of 1988. A coalition of tenants and various community action groups began negotiating with BNE to purchase the buildings. By the summer of 1989, the bank was anxious to sell the property and scheduled a public auction to try to sell the buildings. Bok related the mobilization of citizens in reaction to the auction:

> "The coalition tried to obtain financing to be able to make a bid at the auction but was unsuccessful. Public protest brought out over 350 people who staged demonstrations and caused disruptions during the auction proceedings to stop the sale. Potential bidders were discouraged by the tenants who were afraid that the buildings would be sold piecemeal to private developers. In the end, only two buildings were purchased through the auction with the bank taking back the rest."[2]

BNE gave Salem Harbor 90 days to put together a proposal for buying and developing the buildings. With the help of a number of consultants including Community Builders as development consultants, The Architectural Team, and C.W.C. Builders, a firm familiar with the renovation

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2 Interview with Viki Bok, Executive Director, Salem Harbor Community Development Corporation; Salem, Mass.; July 8, 1991.

of older buildings, they presented a proposal to BNE. By late 1989, BNE was willing to sign an agreement giving the CDC site control and take the buildings off the market. Another year of negotiations went on before a purchase and sale agreement was signed with a $25,000 down payment from the CDC.

Since the auction of 1989, the CDC and the bank had been in active negotiations to establish the price and terms of the sale and to assemble the necessary financing to make the project feasible. The project relied on a combination of debt financing from BNE and a consortium of local banks; equity in the form of tax credits; grants from affordable housing programs; and subsidies from the state and federal government. The challenges of assembling the package illustrate some of the problems that many CDCs experience in trying to purchase an OREO property.

Obstacles

Access to Information - BNE was taken over by the FDIC in January 1991 and sold to Fleet/ Norstar of Rhode Island in July 1991. At that time, the OREO property was part of a holding company within the bank called Small Frye Properties.[3] During that tumultuous period for the BNE, Salem Harbor dealt with the same OREO officer but seven different loan officers with varying degrees of interest or expertise in community lending, according to Bok.

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3 Ibid.

OREO Pricing - The original loans for the buildings had been approximately $4 million.[4] The bank had one appraisal done for each building in July 1990, as opposed to the buildings as a package, in an effort to support their high asking price. According to Bok, the bank had an expectation of $1.2 million while the CDC could only afford an acquisition price of $600,000, based on the loss of RDAL, the project's proforma, and the amount of rehab needed because of the condition of the buildings.[5]

The developers were particularly frustrated by the lack of communication between the OREO officers and the lending side of the bank. Tanner and Bok described how the OREO staff did not appear to be familiar with community lending nor recognize the relationship between the financing terms and the price that the CDC was able to pay for the properties.

> "The CDC was negotiating two sides with the bank - the financing and the price - but the two officers would not work out the terms of the two pieces together to make the deal work for the CDC and get the bank a better price for the property overall."[6]

The CDC had its own limitations that it was working under: rents had to be below a certain level to meet the income requirements for the targeted families; rehabilitation had to meet certain standards; and the package of pricing and finance had to fit to make it work.

Bank Financing - Before it was taken over by the FDIC, BNE was in a very vulnerable position because of loan losses that were closely watched by the

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4 Telephone interview with Russ Tanner, Community Builders; Boston, Mass; July 12, 1991

5 Bok, July 8, 1991

6 Ibid

FDIC regulators. In spite of the pressure, the bank was willing to make a construction loan because it "fit their business plan and showed that it was still doing business", according to Tanner.[7] The bank imposed a number of extraordinary terms and conditions on the loan to mitigate its risk, which were costly to the project. Bok offered some examples,

> "The bank required an extra six months of construction interest at two points higher as a reserve in case the rehab was not finished in the time scheduled, which cost the project roughly an additional $140,000. The bank was unwilling to make any representations or warranties on the condition of the buildings including the lead paint liability."[8]

One of the reasons the CDC stayed with BNE was because of the pressure from the other banks. Bok related that it was the general feeling among the other participating banks, that had formed the local consortium for part of the permanent loan, that BNE should provide permanent financing. The CDC proposed a purchase money mortgage close to $2 million to BNE but it would not make that large a loan and instead wound up supporting only $450,000.[9]

Credibility for CDCs - The first problem that the CDC ran into in negotiating with the bank, was the need to prove the viability of the organization and the feasibility of the project. The formation of a strong development team in the beginning was needed to establish that credibility and give the bank the necessary comfort level to be assured of the viability of the project.

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7 Tanner, July 12, 1991
8 Bok, July 8, 1991
9 Tanner, July 12, 1991

Salem Harbor, like most small CDCs, did not have the necessary seed money for pre-development feasibility expenses or cash to make a down payment to the bank to hold the property. Bok described the involved process of finding the funds to pay all of the up-front costs. Community Economic Development Assistance Corporation (CEDAC) provided the $25,000 down payment and another $25,000 for pre-development. A total of $538,000 was needed prior to closing the loan to cover costs for CDC staff time, architects, surveys, legal fees, development consultants, permits, and more. Salem Harbor was able to raise some of these funds by donations from local churches, foundations, CEDAC, and by asking participants to wait until the closing to be paid.

Financing Structure

Guaranteed Income - An important ingredient in the funding mix that the CDC was depending on was the state Rental Development Action Loan (RDAL) Program which provided an operating subsidy to supplement the low rents. The RDAL subsidy was spread over 20 years and was worth a present value of approximately $1.5 million. The limbo state of the Commonwealth's budget cuts during early 1991 meant that the Salem Point deal could not be closed until the fate of that program, as well as others, was decided.[10] In July, Governor Weld approved the state budget, which left a short fall of $900,000 in the RDAL program. Some projects that were in the pipeline to receive funding, like the Salem Point Cooperatives, were left out because of the short-fall. Furthermore, the 707

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[10] Bok, July 8, 1991

Rental Subsidies were slashed by 35 percent which meant no new 707 certificates. This was another source that the project had been counting on to make it work.

Bok was frustrated because after months and years of negotiating with banks and applying for special grants and loans the project was forced to go back to the lenders and equity participants to ask for another $1.5 million to restructure the deal causing more delays for BNE and the tenants waiting for housing.[11]

Tax Credits - LISC was able to syndicate $2.3 million in tax credits through the National Equity Fund netting $1.5 million to the project. The basis for the credit was on 50 of the 77 units meeting the low-income requirements. Because the buildings were in a low-income "hard to develop area", the project qualified for 130 percent of value. For investors this meant that instead of nine percent (9%) they were earning 11.7 percent in credits. More equity was possible if the number of qualifying units was increased to 60 but that depended on receiving an allocation increase from the state which the CDC was able to obtain.

Salem Harbor had explored the possibility of obtaining tax credits through the MHIC banks, which could provide a higher net to the project than LISC, but the CDC ran into problems. "MHIC had just started its program when Salem Harbor applied," said Bok, "and the 'streamlining process', that was suppose to make it easier to get credits, was not in operation."

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[11] Ibid.

The CDC tried to market the credits to each bank but they were not very receptive. "Tax credits for inner city projects with a high percentage of very low-income units, like Salem Point, were a hard sell to investors", according to Bok.

Another concern was timing. LISC's tax credit pool had been raised in 1990 and Bok was concerned that investors would not be willing to wait and would put their funds into other projects that were ready to proceed.

Long Term Financing - A total of $2.8 million in permanent financing with a 30-year amortization was obtained from a variety of sources. The Bank of New England was providing the construction loan but only $450,000 of the permanent mortgage at 10.5% interest. The Massachusetts Government Land Bank, which makes mortgage loans ranging from $250,000 to $2.5 million to affordable rental housing and limited equity cooperatives, was providing $1.4 million at 7% interest. The third piece was $950,000 at 10.5% interest obtained from a consortium of all nine banks with offices in Salem. Bok related that when she first approached the lenders, over a year ago, the banks balked at bailing out BNE from its problem. Others claimed that they "were already making loans in that neighborhood." But public pressure, BNE's agreement to do a larger share of the financing, and a few well placed news stories turned the bank presidents around and they agreed to participate on the condition that every local bank be a part of it.[12]

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12 Ibid.

Because of the state funding cuts, the CDC was going to ask the banks to reduce interest rates slightly to lower the debt service. Bok explained that, "A bigger mortgage would not help the project because rents were too low to cover the debt. The solution had to be more equity, lower interest rates, or a lower acquisition price."

Blended Interest Rate/Partial Equity Grants - In spite of the combination of tax credits and multi-layered permanent financing there was still a gap of $1,455,000. To fill that gap, the CDC pieced together a series of grant programs. The CDC had to go back to these sources to try to get more money to cover the loss of the RDAL program. The table below compares the original and proposed gap financing.

Salem Point Cooperative
Sources of Gap Financing

Program	***Original Grants***	***Proposed Grants***
FHLBank AHP	$655,000	$655,000
Housing Innovations Fund	500,000	800,000
Community Development Block Grant	200,000	400,000
Weatherization	60,000	60,000
Misc.	40,000	40,000
TOTAL	$1,455,000	$1,955,000

Source: Salem Point Operating Proforma June 17, 1991

Loan Pools - 'The AHP grant was funded through Warren Five Cents Savings Bank in Peabody. Tanner explained that initially the CDC had planned to get a $2 million loan at a discount rate but the bank was unable to sell that loan on the secondary market and found it impossible to carry it on its books. Instead it was willing to convert the interest rate write-down into a grant with provisions to recapture the funds in case the project failed and was converted to a market rate rental.

Financial Model

The Salem Point project was in a state of flux at the time of this writing because of the loss of operating subsidy from the state RDAL program. The proforma that was prepared in June 1991 was used for the feasibility analysis in *Exhibit B* but it was in the process of being modified as the development team negotiated with the financing partners to fill the gap. A comparison of Operating Proformas with and without the RDAL funding illustrates the impact of the loss of the operating subsidy to the project. At the proposed financing levels there was a negative cash flow of $131,439 a year.

EXHIBIT B
PROJECT FEASIBILITY ANALYSIS
SALEM POINT COOPERATIVE

PROJECT ASSUMPTIONS

	Amount	*Monthly Rent*
Number of Units:	77	$577
0-1 Bedroom:	0	
2 Bedroom:	48	$530
3 Bedroom:	29	$656
Operating Costs:	$4,265	per unit/yr
Vacancy Rate:	8%	per year
Replacement Reserves:	$275	per unit/yr
Affordability: 19% Very-low, 45% Low-, and 35% Moderate-income		

OPERATING PROFORMA

	Stabilized Yr w/o RDAL	*Stabilized Yr W RDAL*
Gross Rental Income	533,568	533,568
Vacancy	42,685	42,685
Net Rental Income	**490,883**	**490,883**
Operating Costs	328,405	328,405
Replacement Reserves	21,175	21,175
Net Operating Income	**141,303**	**141,303**
Subsidies (RDAL)	0	156,500
Income Available for Debt	141,303	297,803
Debt Service, 1st Mort	119,066	119,066
Debt Service, 2nd Mort	49,396	49,396
Debt Service, 3rd Mort	104,280	104,280
Cash Flow	**($131,439)**	**$25,061**
Debt Service Coverage	84%	84%
Loan to Value Ratio	33%	33%

SOURCES OF FUNDS

	Amount	*Interest*	*Percent of Sources*	*Term*	*Source*
Equity:	1,540,000		26.2%		Tax Credits
1st Mortgage:	1,491,370	7.0%	25.3%	30	Land Bank
2nd Mortgage:	450,000	10.5%	7.6%	30	BNE
Other Loans/Grants:	950,000	10.5%	16.1%	30	Consortium
Gap Financing:	1,455,000		24.7%		Grants
Total Sources	**$5,886,370**		**100%**		

USES OF FUNDS

	Total Cost	*Per Unit Cost*	*Percent of TDC*
Acquisition Cost	800,000	10,390	13.7%
Rehabilitation Cost	3,234,000	42,000	55.3%
Soft Costs	1,434,548	18,630	24.5%
Development Fees/Consultant	376,900	4,895	6.4%
Total Development Costs	**$5,845,448**	**$75,915**	**100%**

Source: Salem Harbor CDC June 1991

RENWOOD COMPANIES

The Developer

Renwood-CCC Housing Partnerships was a private for-profit development company organized in 1988 as the Boston based development arm of Renwood Companies. Renwood-CCC in Boston was involved in real estate acquisitions, construction, syndication and management of affordable housing under the direction of Caleb Clapp. Through public/private partnerships with the City and federal agencies, Renwood-CCC had developed and owned 15 housing projects totalling 127 units. In a short time the company had gained a great deal of favorable publicity and city support for turning dilapidated buildings and former "crack" houses in Dorchester and Roxbury into rehabilitated family housing. The company had developed a close relationship with Boston's Public Facility Department which had provided land and funding for some of the most run down apartment buildings in Boston. Renwood's objectives, as stated in one of their funding applications:

> In choosing properties to acquire, Renwood selects those that when restored will have the most positive impact on their neighborhood. "Crack" houses and blighted properties abound in Roxbury. Every acquisition Renwood makes is justified by the fact that when rehab is completed, more quality rental housing becomes available in the neighborhood and urban blight is reduced.[13]

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[13] "Application for Affordable Housing Program"; Renwood-Cunard Limited Partnership; Federal Home Loan Bank of Boston; Boston, Mass.; Spring 1991.

The parent company, Renwood Companies, had developed or was a general partner in over 3,000 units of affordable housing, handicapped, or elderly housing.

Renwood-CCC was familiar with the loan pools and had used the AHP financing for a project on Cunard Street. The company had rehabilitated three multi-family apartment buildings totalling 17 units in Roxbury through a joint sponsorship with the Boston Public Facilities Department. The project was completed and occupied but was caught in a work-out situation after the construction lender went into receivership and was held by the FDIC. Permanent financing was needed. AHP funds were sought as either an interest-rate subsidy loan or a grant. Clapp found that banks were unwilling to give him a loan because the AHP loans could not be bought on the secondary market and therefore the loan would have to stay on the bank's books. The bank did not want to carry the loan because it could not handle any more debt.[14] He was given a grant which helped, but he had to find permanent financing elsewhere. Salem Harbor experienced the same situation.

Renwood put together a new proposal to purchase an OREO property on Huntington Avenue that was held by three different banks. At the time of this writing the deal was still evolving. The developer requested that the project and banks not be identified because it was still under negotiation. The figures used in the analysis were current at the time but may not reflect the final outcome. The project does point out a private developer's experience

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14 Interview with Caleb Clapp, Renwood-CCC; Boston, Mass.; July 1, 1991

and a number of interesting problems in dealing with an OREO building owned by multiple banks.

The Project

The project on Huntington Avenue was a 97 unit building with 93 residential condominium units and three units of commercial. There were five one-bedroom units approximately 460 square feet in size and 88 studios ranging from 285-320 square feet. The building was close to the Northeastern University Campus and had been a very desirable, well managed apartment house for music students until 1986. In 1986 a developer converted the building to condominiums, without rehabilitating it, and sold units to about 20 investors.

Renwood-CCC was interested in using the building for mixed-use special needs housing for victims of AIDS, the mentally disabled, and handicapped persons who were under social service supervision and had difficulty in finding housing in conventional projects.[15] Clapp had hoped to obtain special federal funding through programs, like the Section 8 Moderate Rehab Program, that were specifically earmarked for single room occupancy (SRO) housing that fit the groups he was trying to serve. He believed that the building would be difficult to use for market-rate or student housing because of the low rents, high vacancy, and high management and operating costs. While current market rents were about $445, the Section 8 rents for SRO housing were as high as $545 for studio units.

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[15] Ibid.

The broker for the property had approached a number of CDCs to see if they were interested in the building. Some possible uses included elderly housing, an AIDS hospice, or a shelter for battered women. The type of use would dictate the amount of rehabilitation or adaptation needed to make it function for the targeted group.

OREO History

Ron Geddes, the broker for the property, related some of the history of the project's current status.[16] The original investors bought the units for approximately $50,000-60,000 during the height of the escalating Boston real estate market. Only 10 of the units were actually owner-occupied while the remainder were turned over to a management company for rentals. The project was not professionally run and began to go downhill. There were problems with drug dealers and owners who were not keeping up payments with the homeowners association so the project deteriorated quickly. The real estate market began to soften and rents were spiraling downward leaving owners with mortgages of $30,000-40,000 and no rent or appreciation to cover them. So owners began to default and the banks foreclosed.

This project was not unlike other condo conversions bought by speculators. Eighty of the mortgages were owned by only three different banks, Banks X,Y, and Z. Bank X, which was a savings and loan still in operation but on the "watch" list of the regulators, had 51 units. Seventeen of the units the bank owned outright, 21 were in some state of foreclosure and the remainder were more or less current on their mortgage payments. Bank Y, also a savings and

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[16] Interview with Ron Geddes, Managing Broker; The Prudential Gibson Real Estate; Boston, Mass.; July 9, 1991

loan but in healthy shape, had 20 units which it owned outright. Bank Z, a defunct credit union, had 10 units it owned outright and the remainder were in foreclosure. The 10 units that were not part of the investor group were still current in their mortgages but in trouble. Some owners were considering selling their deeds back to the bank, in lieu of foreclosure.[17]

In 1990 the project was listed with a broker for $30,000-40,000 per unit but none of them sold. The listing in January 1991 was for $24,000 per unit but offers were in the range of $6,000-14,500 per unit.[18]

The project seemed attractive to Clapp but there were a number of problems he faced in dealing with the OREO property.

Obstacles

Rivalry Among Banks - According to Geddes, the biggest obstacle to a buyer trying to purchase this property, was the inability of the participating banks to agree on anything. "Each bank believed that its units were unique because of condition or location and should be priced accordingly. The range in unit prices fluctuated with each appraisal yet there was no realistic difference in them," said Geddes. The deal terms, whether cash or loans, were also a source of disagreement. The broker had urged the banks to draw up a memo of understanding outlining the prices, terms of sale, and materials that were required by the loan committees but no one could agree. Geddes explained that, "One bank wanted the buyer to pay all the taxes while another bank did not care. One bank wanted a broker to

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[17] Ibid.
[18] Ibid.

handle the entire process to keep an arms length transaction while another bank did not want any broker and wanted to handle it all in house. They disagreed about broker fees and had a narrow view of the real valuation of the property".[19]

OREO Pricing - Clapp, like most of the prospective buyers, was only interested in purchasing the project as one complex to obtain control of the condominium association and the operating budget but each unit was priced differently. An offer by a buyer other than Clapp, that was accepted by Bank X for $14,500 cash per unit, was rejected by Bank Y because it believed the units were worth $18,000, according to Geddes. Appraisals at the time showed that the units ranged from $11,500-19,000 in value which put the deal right in the middle, yet it was rejected by one of the banks. The deal fell apart when the buyer backed off because an agreement could not be made.[20]

The banks were deliberately not re-renting the units as they became vacant to avoid relocation hassles and to make the project more marketable to one buyer.[21] The amount of vacancy added to the carrying costs of the project which included taxes and the operating costs for the condominium association. The longer the banks held out for a slightly higher price the more it cost each month.

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19 Ibid.
20 Ibid.
21 Ibid.

Bank Financing- The ability of each bank to provide financing for the sale was partially due to regulatory restrictions and the capital reserves of the bank. Geddes explained that Bank X was a thrift and under "watch status" by OTS which would not allow it to provide financing. Bank Y was a thrift in better financial condition and did not have the restrictions In fact, its loan committee was very anxious to provide financing if it meant speeding up the sale.[22]

Financing Structure

Guaranteed Income - The mixed-use special needs housing proposed by Clapp relied on tenants using project based Section 8 Certificates under the Mod Rehab Program. Under the program for SROs the rents were set at 120 percent of fair-market value which was $547, including utilities, versus the current rent for studios in the area of $445. Eligible tenants with certificates only had to pay 30 percent of their income for housing with the difference made up by the federal government.

Tax Credits - The developer was not proposing to use tax credits under the proforma on Exhibit C. The Mod Rehab Program required a long and complex HUD review if tax credits were used with the project. The time involved would have jeopardized other financing associated with the proposed project.[23]

Long Term Financing - Clapp was seeking permanent financing for the project from the Land Bank Fund or the FHLBank Affordable Housing

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22 Ibid.

23 Clapp, July 19, 1991

Program. The project could support a $850,000 loan at an interest rate of 10.5%. Applications for funding had not been made since the deal was still in negotiation.

Blended Interest Rate/Partial Equity Grants - The major source of gap funding for the project, $750,000, was to come from the Boston Public Facilities Department through the Community Development Block Grant Program. The grant did not have a pay back requirement unless the project produced a positive cash flow or was converted to a noneligible use.[24]

Financial Model

The Renwood Project was still in negotiation at the time of this writing so the proforma does not reflect the final deal. *Exhibit C* illustrates the project costs that can be used as a basis of comparison with the Salem project and the MHIC model.

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24 Ibid.

EXHIBIT C
PROJECT FEASIBILITY ANALYSIS
RENWOOD - CCC

PROJECT ASSUMPTIONS

	Amount	*Monthly Rent*
Number of Units:	50	$547
0-1 Bedroom:	50	
2 Bedroom:	0	
3 Bedroom:	0	
Operating Expenses:	$3,845	per unit/yr
Vacancy Rate:	3%	per year
Replacement Reserves:	$275	per unit/yr
Affordability: 100% Very-low or Low-income		

SOURCES OF FUNDS

	Amount	*Interest*	*Percent of Sources*	*Term*	*Source*
Equity:	25,633		1.6%		Cash/Owner
1st Mortgage:	850,000	10.5%	52.3%	30	Land Bank
2nd Mortgage:	0				
Other Loans:					
Gap Financing:	750,000		46.1%		BPFD Grant
Total Sources	**$1,625,633**		**100%**		

OPERATING PROFORMA

	Stabilized Year
Gross Rental Income	328,200
Vacancy	9,846
Net Rental Income	**318,354**
Operating Costs	192,250
Replacement Reserves	13,750
Net Operating Income	**112,354**
Subsidies	0
Income Available for Debt	112,354
Debt Service, 1st Mort	93,303
Debt Service, 2nd Mort	
Cash Flow	**$19,051**
Debt Service Coverage	84%
Loan to Value Ratio	33%

USES OF FUNDS

	Total Cost	*Per Unit Cost*	*Percent of TDC*
Acquisition Cost	750,000	15,000	46.1%
Rehabilitation Cost	414,750	8,295	25.5%
Soft Costs	215,883	4,318	13.3%
Development Fees/Overhead	245,000	4,900	15.1%
Total Development Costs	**$1,625,633**	**$32,513**	**100%**

Source: Renwood-CCC June 1991

CASE ANALYSIS

The two cases point to some basic differences between a nonprofit developer and private developer of similar size. Clearly Renwood had more of a track record in affordable housing development and the backing of an experienced and well-capitalized company, but the day to day operation was managed by only a few people. The track record with project sponsors like the Boston Public Facilities Department and the AHP gave the company immediate credibility with the bank. Salem Harbor, on the other hand, had very little experience and no capital. It had to assemble a team of experts before the bank would even talk to them about the feasibility of the project.

The fit between the OREO property in the Salem Harbor neighborhood and the objectives of the local CDC was very good. The CDC had been able to obtain strong backing from the tenants, community advocacy groups, public officials and local banking institutions. As a CDC it was able to mobilize the tenants and solicit help from other service agencies to fight for the project. That kind of support does not usually happen with a private development.

As private developer, Renwood was attempting to do a joint venture with nonprofit service providers as a way of creating a unique form of affordable housing for special needs groups. This form of specialized housing and the link with nonprofits gave the developer special access to public funding sources that would make the project feasible. Renwood, as landlord, would retain responsibility for the physical upkeep of the buildings but the management would be turned over to special social service groups who could work with the tenants.

Both developers had an objective to improve the physical condition of the buildings and stabilize the neighborhood by rehabilitating the projects and interjecting strong management. There was a further desire to get away from the absentee owner cycle and bring the units back to economic life to provide needed housing for families in one case, and special needs individuals in the other.

The circumstances of the OREO ownership by the various banks were different but but the terms of the sale all boiled down to time and money. The Renwood proposal did not require the OREO banks to provide financing and the developer was offering an acquisition price of $15,000 which was within the appraisal range. The longer the banks waited the more it was costing them in condo fees and taxes to keep the units vacant, yet the banks were caught in a rivalry that prevented any action. Salem Harbor was in a different position with its bank. The project depended on the bank providing financing and a deep discount on the price. The rundown condition of the buildings required rehabilitation work that was over 55 percent of the value of the completed units. It seemed unrealistic for the bank to expect more than $10,000 per unit given the condition and location. Having invested two years in negotiations and a lot of publicity, the bank was probably in to deep to back out of the funding commitment. In BNE's case, the project was in a low-income neighborhood that should be part of the banks CRA lending and therefore the sale of the OREO project and subsequent loan should be used to improve its rating. Whether this was part of the criteria is not known.

The entire feasibility of both projects depended on funding commitments from loan pools or grants. It also relied on the federal and state rental subsidy programs to achieve high enough rents to even cover the 33 percent loan to value ratios that were anticipated for both projects. The income stream from the projects could not support more debt unless interest rates were lowered. The projects needed more equity or grant money to make up for the operating loss. The impact of the RDAL program was clearly demonstrated in the Salem Harbor project and points out the problems that any developer has in trying to do a low-income project whether it is OREO or not.

Financial Model

The proposed financing scheme for Renwood was much simpler in some ways than the Salem Point project because there were fewer parties involved, but it was just as reliant on gap financing. The total development costs ranged from a high of $76,000 at Salem Point to a low of $32,500 at Renwood and compared to $56,000 in the MHIC model. The difference in the size of units and the amount of rehab accounts for most of the difference between the two projects.

Developer fees and overhead for Renwood were 15 percent of total development costs as opposed to Salem Harbor which had development fees and consultant costs equal to 6.4 percent of the project. The per unit costs for development fees were about the same at $4,900. Both projects had higher fees than the MHIC model which were pegged at 4 percent of project costs.

The MHIC model assumed a loan to value ratio of 60 percent that depended on support by the Section 8 rents, however both projects found that the rental income could not support a debt of more than 50 percent of the project costs.

CHAPTER 6
CONCLUSIONS

This thesis explored a real estate issue that was the current topic of controversy among news articles, bankers, housing agencies, federal regulators, and developers trying to find the best way of disposing of foreclosed housing in Massachusetts. The underlying premise of this paper was that the banks were in an opportune position to help developers create affordable housing by combining new funding programs that they sponsored, together with surplus housing that they were trying to sell. The research for this thesis revealed that there were a number of major obstacles involving regulatory restrictions, limited availability of permanent financing, and a lack of cooperation from the banking community that were inhibiting the conversion of foreclosed property into affordable rental housing.

Housing providers were frustrated in dealing with the local banks, as well as the RTC and FDIC, which seemed anxious to sell but were unable to complete many transactions because of inefficient management, unrealistic appraisals, drawn-out negotiations, lack of essential financing, and inexperience in financing low-income rental housing. Using foreclosed property for affordable housing did not mean that the sellers had to take less than market value for the property but it did require more creativity and a little more time to complete a sale. It made good sense from a business view point for the reluctant property owners, because it reduced the management and holding costs of the property. At the same time, it made good social sense for the community by restoring these housing resources to useful economic life.

New information about problems and recommendations for solutions were changing daily as people became more knowledgeable about the issues. MHP was particularly instrumental in promoting new opportunities for working with banks by sponsoring two housing workshops for local officials, CDCs, bankers, and housing partnerships. This chapter presents a number of recommendations, suggested by participants at those workshops and in the interviews, for resolving some of the obstacles identified in Chapter 4 and experienced by the developers in the case studies in Chapter 5.

SOURCES OF FUNDING

Use of Loan Pools

An underlying premise in this thesis was that the new funding sources for affordable housing, created through government mandate or lender consortiums, could be coupled with low-cost bank-owned property to make an affordable rental project feasible. The evidence from Joe Flatley at MHIC and John Eller at FHLBank indicated that member lenders were reluctant to use these loan pools to "bail-out" each other from bad lending decisions. Competition among projects vying for limited funding resources was fierce. There was a perception among the administering agencies and board members that these funds should be used for new social investment in the community and not as a bank bail-out. Sensitivity to bad publicity and the negative public perception of banks were very influential in determining this view point. MHIC was specifically cited by the press for not lending money fast enough ($8.9 million), while in reality it had raised almost half ($48.5

million) of its five year goal ($100 million) of bank commitments in the first year of operation.

The Bank of New England was pressured into providing permanent financing for the Salem Harbor project because the other banks in town would not lend otherwise.

Another part of the loan pool issue related to how effective the pools were in meeting the financing needs of the affordable projects. Aside from the $6 million yearly in the AHP funds, the other programs were targeted for short term rehabilitation or construction loans rather than permanent mortgages which seemed to be the real need. The MHP Interstate Banking Funds (Chapter 102, Fleet/Norstar acquisition of Bank of New England) targeted to permanent mortgages would help to resolve that problem.

The other big gap, that could be filled by the loan pools, was the need for initial risk financing for down payments or auction money to enable developers to obtain site control and be able to negotiate a better price with the bank. MHP was on target in developing guidelines for the use of Chapter 102 funds for this purpose.

Permanent Financing

The inability to obtain permanent financing for affordable housing was a problem shared by both nonprofit and for-profit developers. It was a particular problem in the case of OREO property for a number of reasons. Banks wanting to sell off distressed property quickly were not always willing to make a sale contingent on long term financing: they wanted cash and no terms. The Renwood project was a case in point. Those that did offer permanent financing, as in Salem Point, were not as willing to lower the price. Financing terms were limited in order for banks to comply with regulatory restrictions so that the transaction would be counted as a true sale and the bad loan could be taken off the bank's books.

Permanent lending for affordable rental housing was further constrained by the inability to sell the loans on the secondary market. Tighter lending criteria, higher capital reserves, and the general health of the bank made it difficult for some banks to carry large permanent mortgages on their books if they could not sell them in the secondary market. Both Salem Harbor and Renwood experienced this problem when trying to use AHP funds as permanent financing for their projects. Efforts were being made by lenders, community agencies, institutional investors and the government to try to standardize the loans so that they could be packaged and sold on the secondary market.

The standardized lending structure that was prepared by MHIC, and used in the model for feasibility analysis, was a start in building a uniformity to the loans that would make them more marketable for institutional investors like pension funds. It was a slow education process for the fund sponsors, as Amy Anthony from AEW pointed out. Secondary markets and pension funds require loans to be packaged together to form a large enough pool of at least $10 million to warrant the investment. It would require a more rigorous review of developers and projects to create such a pool before the investors would be comfortable with affordable housing as an investment category.

Shared Risk Lending

Another problem with permanent financing, especially with the loan pools like AHP, was that the banks were unwilling to take the risk of a large loan especially for an affordable rental project that may not have the back-up subsidies for operating expenses and rent guarantees from the federal or state programs. This was the case with Salem Harbor.

One solution suggested by Warren Smith of Boston Bank of Commerce, would be to parcel out shares of the loan to other banks. A member bank in the loan pool would have to take the lead and be responsible for the application but there would be a need to protect the member bank from full liability if the loan were to default. The amount of liability that the other banks would share was an issue that needed resolution. Participants who were also pool members could share liability in accordance with their part of the loan while non-members could provide letters of credit. FHLBank, in response to the problem, was developing enhancement vehicles like a letter of credit to help market AHP loans for permanent mortgages.

SOURCES OF PROPERTY

Trading OREOs Between Banks

Banks holding OREO property were faced with the dilemma of trying to sell an asset to get the loss off their books and, at the same time, needing to provide financing to the new owner in order to make the sale. Regulatory restrictions sometimes made the two pieces difficult to reconcile.

One way out of the dilemma would be for banks to agree to swap OREO property loans so that the transaction would be counted as a true sale. The trade-off between banks would solve the problem for both the lender and the buyer, especially in the case of a CDC or small developer who usually required permanent financing. The new bank holding the problem asset would not have the same loss write-offs and could lend more easily under CRA criteria. That kind of swap may have been possible in the Renwood project where three banks owned similar units in the same building. To make this work, banks must first get past the rivalry and personality conflicts.

Packaging OREO Property Together

Packaging a number of OREO properties together, as in the case of Salem Point Cooperatives, serves a number of purposes for both the lender and the community. For the bank, it takes them out of a number of bad loans that individually may not be marketable or could result in a number of small transactions that can be time consuming, costly, and problematic. For the community, packaging could mean a major reinvestment in a neighborhood that may have been suffering from a blight and deteriorating situation because of absentee ownership. The CDC lends itself to facilitating this kind of turnaround because of its strong ties to the community and close association with the residents.

The packaging of condominium units in the Renwood project, illustrates another benefit to the building and the banks. Under single ownership, the building could be used for special needs groups and be managed more efficiently than as a condo association comprised of absentee owners.

Another example was the RTC auction which had three projects with at least seven condominium units in one building. If these units represented a majority share of the condominium association it could provide a viable rental opportunity for affordable housing. Liquidators need to take a closer look at the projects they are selling and work with the developers to identify packages for affordable rentals before they get to the auction block.

Unfinished or unsold condominium projects, such as the projects that Winn Development Company purchased in Quincy and Revere, are another source of property. Rather then the bank playing developer and selling off each condo separately, a CDC or private developer could step in to turn the whole building into a mixed-income project for ownership or rental.

Relationship Between OREO and CRA

Most banks seemed to keep their OREO officers and their CRA obligations separate. Only a few were actively looking for ways that the two functions could be combined to be more effective in providing affordable housing as part of community lending. While the CRA officers were familiar with local community groups, special lending criteria, and financing programs, the OREO staff was not. In some cases the OREO liquidators, like the Hunneman group, were outside consultants and real estate brokers with very different agendas - namely to sell the property rather than look for opportunities to serve a social need.

Part of the issue is getting the banks to acknowledge the tie and assign appropriate staff to try to coordinate an implementation plan. That kind of coordination would have helped facilitate the negotiations in the Salem Harbor project.

The other part is a regulatory issue that may require changes in banking guidelines. Banks are closest to understanding the conflicting mandates of "safety and soundness" under CRA and "loss recognition" limits under OREO disposition. Different regulators monitor each of these areas and banks are caught in the middle. CHAPA and the American Jewish Congress is working on raising the issue among the bankers, regulators and the housing providers as a first step in resolving some of the conflict that could ultimately help to facilitate the disposition of property for affordable housing. The Massachusetts Bankers Association, the Massachusetts Community and Banking Council, or the National Association of Affordable Housing Lenders are three organizations which would be helpful in facilitating such a discussion.

THE DEVELOPERS

Joint Venture Between CDC and For-profit Developers

Many CDCs were caught in the same funding crunch as private developers. Staff was cut back, administrative funding was reduced and affordable housing production programs were becoming more competitive. The lack of up-front cash and development expertise was costly to the CDCs, like Salem Harbor. Searching for pre-development capital and paying high fees for development consultants meant that project costs were getting higher.

For-profit developers for affordable housing were facing their own problems. There were limited new construction opportunities because of the over supply of housing, limited access to funding pools that gave priority to nonprofit developers, and wary community support for affordable projects. The reputable, financially-solid private developer generally had more development and construction experience than some of the CDCs and usually could raise the cash needed to close a deal quickly without drawn-out financing contingencies.

A joint venture between a CDC and a for-profit developer could solve both their problems for OREO development as well as any affordable rental project. For the CDC, it would obtain up-front financing and development expertise to prepare financial analysis and handle the management of the renovation work. The responsibility of applying to funding programs, working with tenants, and managing the finished project could be born by the CDC. The CDC could also bring community and political support, as well as access to special funding if needed. The combination might also make a more credible borrower for institutional investors. Both parties could share in the development and management fees to make the joint venture lucrative for each. The Renwood proposal to combine private developer, as landlord, with nonprofit service groups, as managers, is the kind of joint venture that could be pursued.

BEYOND MASSACHUSETTS

It should be recognized that the need for affordable housing and the problem of foreclosed property are not unique to Massachusetts but are problems shared by many regions of the country. What is different in Massachusetts is that the Commonwealth has an established network of CDCs, housing service agencies, bank consortiums, and developers who are able to mobilize quickly to respond to new the housing opportunities. The advocacy work of MHP and CHAPA to raise the issues about affordable housing and propose modifications to federal legislation regarding FDIC and RTC property, will ultimately be beneficial to other regions of the country. The loan pools sponsored by MHP and MHIC could also be replicated in other states looking for new funding resources for affordable housing. In particular the Massachusetts legislation regarding Interstate Banking, which created a source of loan funds for low-income housing, was enacted at an opportune time to take advantage of the move toward consolidation in the banking industry. That kind of legislation could be enacted in other states.

The availability of large quantities of foreclosed property represents a unique period in real estate and lending history. Economists predict that the cycle of foreclosure and the absorption of the surplus residential property could last another three to ten years. The lenders and developers in Massachusetts are experiencing the beginning of the learning curve in terms of understanding how they can combine forces to dispose of foreclosed property in an expedient and sound manner while creating a housing opportunity for families in need. Resolving the issues raised in this thesis will bring affordable rental housing one step closer to implementation.

GLOSSARY

AHP - Affordable Housing Program - Federal Home Loan Bank

BNE - Bank of New England/Fleet Norstar

CDCs - Community Development Corporations, nonprofit developers

CEDAC - Community Development Economic Assistance

CIP - Community Investment Program - FHLBank

CHAPA - The Citizens Housing and Planning Association

CRA - Community Reinvestment Act

EOCD - Mass. State Office of Economic and Community Development

Fannie Mae - Federal National Mortgage Association

FDIC - Federal Deposit Insurance Corporation

FHFB - Federal Housing Finance Board

FHLB - Federal Home Loan Bank

FIRREA - Financial Institutions Reform Recovery and Enforcement Act

FSLIC - Federal Savings and Loan Insurance Corporation

LIHTC - Low-Income Housing Tax Credit

LISC - Local Initiative Support Coalition

MBA - Massachusetts Bankers Association

MCDC - Massachusetts Community Development Corporation

MHFA - Massachusetts Housing Finance Agency

MHIC - Massachusetts Housing Investment Corporation

MHP - Massachusetts Housing Partnership

NAHA - The National Affordable Housing Act

NEF - National Equity Fund

NEHF - New England Housing Fund Program, FHL Bank of Boston

OCC - Office of the Comptroller of the Currency

OREO - Other Real Estate Owned, commercial banks

OTS - Office of Thrift Supervision

RDAL - Rental Development Action Loan

REO - Real Estate Owned, savings and loans

RTC - Resolution Trust Corporation

S&L - Savings and Loan Association

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